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# TAX TREATMENT OF LIFE INSURANCE AND RELATED AREAS

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## REPORT OF THE CONSULTATIVE COMMITTEE

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AUGUST 1989





OFFICE OF MINISTER OF FINANCE  
WELLINGTON, N.Z.

30 August 1989

**STATEMENT BY DAVID CAYGILL**

**Report on the Taxation of Life Insurance and Related Areas**

Introduction

I am pleased to release the second report of the Consultative Committee on Superannuation, Life Insurance and Related Areas. The report discusses and makes recommendations on the taxation of:

- life offices and related matters;
- life and disability insurance premiums and claims;
- friendly societies and credit unions; and
- health insurance premiums and claims.

These reforms are related to, and are consistent with, the reforms the Government has already put in place concerning the taxation of private superannuation.

Taxation of Life Offices

The current taxation treatment of life offices is deficient in that only investment income (and not other forms of income) is taxed. In consequence only expenses related to the earning of investment income are deductible. That is an unsatisfactory position from the point of view of both the Government, which fails to collect tax on some of the income derived by life offices, and life offices, which are denied a deduction for expenses for which other taxpayers are allowed a deduction. In particular, at the time the superannuation tax reforms were enacted, life offices argued that the restrictions imposed on the deductibility of their expenses unfairly penalised those who saved for their retirement by investing in a life office.

The appropriate taxation treatment for life offices is a highly technical issue which the Consultative Committee's report considers in some detail. In broad terms, the Committee recommends that life offices receive full deductibility for their expenses but be taxed fully on their income. That involves moving life offices on to a tax system which approximates that applying to other types of companies. It is proposed that the new tax regime take effect from the beginning of the tax year starting on 1 April 1990.

The Government has agreed to the life office regime proposed in the report subject to further consideration being given by officials to possible adjustments to the definition of underwriting income.

### Life and Disability Insurance Premiums and Claims

The Report considers the position of so-called "income maintenance" policies whereby a person insures against loss of profits or income in the case of death, sickness or disability. The taxation law in this area has been subject to some doubt with premiums sometimes deductible (with benefits assessable) while in other cases premiums are non-deductible and benefits non-assessable. The Committee notes that the latter is more in line with the Government's overall taxation reforms but the Committee considered that moving all policies on to a consistent basis would require consideration of the taxation of general (ie non-life) insurance. In the meantime, the Committee recommends that, for the sake of clarity, current Inland Revenue Department policy in this area should be set out in legislation.

The Government has decided that the time and effort required to put the current Inland Revenue interpretation into legislation would be better directed at developing and legislating for an improved regime. The Government has therefore declined this aspect of the Report but agreed that priority be given to consideration of a consistent and more appropriate tax treatment of all insurance premiums and claims.

### Friendly Societies and Credit Unions

Friendly societies and credit unions are currently exempt income tax. The Government announced its intention to remove this exemption in December 1987. The Committee's Report makes detailed recommendations as to how that policy should be implemented. That involves moving such entities on to a normal income tax basis from the income year commencing 1 April 1990.

A proposal which has been controversial is the recommendation that the benefit from low interest rate loans provided to the members of friendly societies or credit unions be taxed. The Committee carefully considered this issue and concluded that the taxation of such benefits is justifiable and necessary. However, in recognition of the compliance costs involved for the smaller organisations, the Committee has proposed not to apply such a rule to already existing friendly societies and credit unions with assets under \$1 million.

Trade unions and working men's clubs are currently exempt income tax under the same provision which exempts friendly societies and credit unions. However, the taxation of those bodies was not within the Committee's terms of reference and no change to their tax exempt status is recommended.

The Government agrees with the Committee's recommendations to move friendly societies and credit unions on to a normal income tax basis except for their recommendations in relation to low interest loans. Further discussions will be held with the Credit Union League on this issue.

### Health Insurance

The previous specific income tax provision providing for the deductibility of health insurance premiums was repealed as from December 1987. At the same time premiums paid by employers for the benefit of employees became subject



to FBT. It was considered that taxation exemptions were not a very fair or effective means of delivering health care assistance. The Committee considered this issue and submissions seeking the reinstatement of tax concessions. The Committee has endorsed the Government's decisions.

#### Summary of decisions on the Committee's Report

In response to the Committee's report the Government has:

- agreed to the Committee's recommendations on the tax treatment of life insurance companies for implementation from the income year commencing 1 April 1990, subject to officials giving further consideration to the definition of underwriting income;
- agreed to the Committee's recommendations relating to the separation of the life insurance and superannuation business of life insurance companies;
- decided not to legislate the current Inland Revenue interpretation of the tax law relating to life and disability insurance premiums and claims;
- agreed that priority be given to consideration of a consistent and more appropriate tax treatment of general as well as life and disability insurance premiums and claims;
- agreed that the tax exemption of friendly societies and credit unions be removed and that such entities be subject to normal income tax treatment as recommended by the Consultative Committee. It is intended that these changes take effect from the income year commencing 1 April 1990; and
- decided to have further discussions with the Credit Union League on the issue of applying FBT to low interest loans made to credit union members.

I would like to thank the Committee for the hard work they have put into addressing some very difficult technical issues. I congratulate the Committee on a detailed and comprehensive report which will facilitate the next stage of the process, namely the drafting of legislation. I also thank those who made submissions to the Committee and, in particular, the Life Offices' Association for its input on the life office regime.

The Government intends to introduce legislation giving effect to the agreed reforms as soon as possible.



David Caygill



Office of the

## Consultative Committee on Superannuation, Life Insurance and Related Areas

PO Box 3724  
WELLINGTON

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18 July 1989

Hon David Caygill  
Minister of Finance  
Parliament Buildings  
Wellington

Dear Mr Caygill

We enclose the Consultative Committee's second report which covers the remaining areas of our terms of reference. This includes the tax treatment of life insurance companies, friendly societies and credit unions. The report also addresses the tax treatment of premiums/contributions to life offices, friendly societies and other health insurers, as well as the treatment of benefits paid by these organisations. These issues were covered in Volume 2 of the Government's Consultative Document on Superannuation and Life Insurance.

The Committee acknowledges the assistance and advice of a number of officials from the Treasury and the Inland Revenue Department, in particular, Allan Archer, Warren Sloan, Kathy Spencer, Greg Frontin-Rollet and Tim Walker.

Yours sincerely

Handwritten signature of Donald T Brash.

Donald T Brash  
Chairman

Handwritten signature of N T Malley.

N T Malley

Handwritten signature of J S Drage.

J S Drage

Handwritten signature of G J Harley.

G J Harley

Handwritten signature of Robin Oliver.

Robin Oliver



# **Second Report of the Consultative Committee on Superannuation, Life Insurance and Related Areas**

## **LIFE INSURANCE AND RELATED AREAS**

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## CHAPTER 1 - INTRODUCTION

### 1.1 Scope of the Report

The Committee's first report covered the tax treatment of superannuation: the schemes, contributions, and benefits. The report was released, along with the Government's decisions, in July 1988. The Income Tax Amendment Act 1989, passed in March of this year, put in place the new Taxed/Taxed/Exempt regime for superannuation. At the same time, the Superannuation Schemes Act 1989 liberalised the regulatory regime and provided transitional measures.

This second report covers the remaining areas of the Committee's terms of reference. This includes the tax treatment of life insurance companies, friendly societies and credit unions. It also addresses the tax treatment of premiums/contributions to life offices, friendly societies and other health insurers, as well as the treatment of benefits paid by these organisations. These issues were covered in Volume 2 of the Government's Consultative Document on Superannuation and Life Insurance.

It should be noted that this report is structured differently from the Consultative Document. In particular, health insurance is covered here in two chapters. Chapter 5 covers the income tax treatment of friendly societies, including those involved in health insurance. The arguments for tax concessions for health insurance generally, together with the tax treatment of premiums and claims in the hands of policyholders, are addressed in Chapter 6.

### 1.2 Objectives of the Review

Life insurance companies are currently subject to a special tax regime which disregards the underwriting activity and focuses only on the investment activity of life offices. Even though the tax base is incomplete, the regime is not necessarily concessional. Indeed the Committee considers that many life offices may have been overtaxed relative to other businesses. The Government decided to review this treatment with the aim of developing a comprehensive base which would tax the investment and underwriting activity of life offices in an even-handed manner. Thus, the tax treatment should neither advantage nor disadvantage life offices or life insurance relative to other organisations and businesses.

Friendly societies and credit unions are currently subject to a concessionary regime which effectively exempts them from tax. This confers an advantage on friendly societies and credit unions at the expense of other organisations involved in the same business activities. For example, the tax treatment of friendly societies has probably contributed to the dominance of friendly societies in the health insurance market. The Committee agrees

with the Government that, by and large, a business activity should be taxed the same, regardless of the organisational form under which the business is conducted.

### 1.3 Submissions Received

The Committee received 98 submissions on the areas covered in this report. The numbers of submissions received on different issues were as follows:

Life insurance	18
Health insurance	11
Friendly societies	22
Credit unions	47

The content of submissions is discussed in the relevant chapters.

### 1.4 Summary of Main Recommendations

The Committee's detailed recommendations are included in the chapters. The following is a summary of the Committee's key recommendations.

#### 1.4.1 Life insurance companies

The Committee recommends that:

- a life insurance be subject to the Committee's Option 2 regime which is modelled on the tax imputation system applying to companies and set out in section 2.4.2 of the report;
- b the tax rate for the life office base be the company tax rate, currently 33%;
- c the tax rate for policyholders be 33% based on the current scale of personal effective marginal tax rates;
- d underwriting income, ie the income earned by a life office in respect of the risk-spreading service it provides, be defined as the sum of mortality profit, a premium loading, and discontinuance profit as set out in section 2.5;
- e actuarial reserves be calculated, for tax purposes, on a basis determined by the life office's actuary, using interest, mortality, and other assumptions that are:
  - reasonable in the light of the life office's experience;
  - consistent with the basis used by the life office's actuary in making recommendations on the level of surplus available for distribution to shareholders and/or policyholders; and
  - acceptable to the Commissioner of Inland Revenue;



- f the deductibility of expenditure incurred by life offices be determined under general tax law;
- g the current law relating to the tax treatment of capital gains realised by life offices be carried over to the new regime;
- h there be no difference in tax treatment for proprietary and mutual companies except what is necessary to take into account a proprietary company's distributions to shareholders;
- i life offices pay FBT on any discounts on interest charged in respect of loans to policyholders;
- j there be no ability to group tax on the policyholder tax base with the income or losses of other group companies;
- k premiums, claims, reserves and underwriting income included in the tax base be net of reinsurance where the reinsurer is subject to New Zealand income tax;
- l by election of the life office and subject to the approval of the Commissioner of Inland Revenue, New Zealand branches of non-resident life offices be treated as New Zealand residents for tax purposes;
- m consideration be given to exempting from tax, overseas sourced investment income derived with respect to overseas operations which is distributed to non-resident policyholders;
- n the new regime take effect from the income year commencing 1 April 1990;
- o the new life insurance regime should apply to all business arising from any contract whereby a person offers benefits contingent on the death or survival of a human life. However, where a person offering such contracts fully reinsures all life/death risks with some other company, the business should not be classified as life insurance; and
- p life offices be allowed to transfer superannuation liabilities and corresponding assets, without a tax penalty, to a separately identifiable superannuation business which would be taxed under the tax regime applying to superannuation. (The Committee's specific recommendations on this issue are discussed in the Chapter 3.)

#### 1.4.2 Life and disability insurance premiums and claims

The Committee recommends that:

- a the tax treatment of all life, disability, and fire and general insurance premiums and claims be reviewed and consideration given to making all such premiums non-deductible and claims non-assessable;

- b the current treatment of life and disability insurance premiums and claims be retained in the meantime; and
- c the current Inland Revenue interpretation of the tax law relating to life and disability premiums and claims be translated into legislation.

#### 1.4.3 Friendly societies and sickness, accident and death benefit funds

(Note: These recommendations apply to all friendly societies, including those involved in health insurance.)

The Committee recommends that:

- a the medical business of friendly societies be taxed as for other health insurers, ie as for a fire and general insurer. The tax base would then be premiums received plus investment income less claims paid less all investment and management expenses;
- b the life insurance funds of friendly societies be taxed as for life insurance companies (refer to Chapter 2);
- c all the funeral, sickness and annuity insurance business of friendly societies be allowed a simplified tax base of investment income less all investment and management expenses, provided that business does not exceed specified limits. Otherwise the life insurance company basis would apply;
- d general tax law (rather than a specific tax) apply to realised capital gains;
- e any interest discount on loans to members, as measured by reference to the prescribed FBT interest rate, be subject to FBT, except where the friendly society:
  - existed and had assets under \$1m as at 1/4/89; and
  - has assets under \$1m at all times during the quarter;
- f the tax rate applying to the income of friendly societies should reflect the effective marginal tax rate of members, at present 33%; and
- g taxation of the income of all friendly societies apply from the income year commencing 1 April 1990.

With respect to Sickness, Accident and Death benefit trust funds, the Committee recommends that:

- a the tax base be premiums received plus investment income (including net realised capital gains) less claims paid less all investment and management expenses;

- b the tax applies from the income year commencing 1st April 1990;
- c the tax rate should reflect the effective marginal tax rate of members, at present 33%; and
- d no concessions apply for provisional tax payments.

#### 1.4.4 Health insurance premiums and claims

The Committee:

- a recommends that health insurance, with the exception of premiums for income replacement policies that are currently deductible, should be paid for by individuals out of their after-tax income;
- b endorses the removal of the previous FBT exemption for employer-paid health insurance premiums; and
- c recommends that the benefits from health insurance policies, with the exception of currently taxable benefits designed to replace income, should be tax free to the insured.

#### 1.4.5 Credit unions

The Committee recommends that:

- a credit unions be subject to the tax treatment applying to co-operatives with an option to account for all income as if it had been derived from dealings with members, thus avoiding the need for an imputation credit account;
- b general tax law (rather than a specific tax) apply to realised capital gains;
- c any interest discount on loans to members, as measured by reference to the prescribed FBT interest rate, be subject to FBT, except where the credit union:
  - existed and had assets under \$1m as at 1/4/89; and
  - has assets under \$1m at all times during the quarter;
- d the tax rate applying to the income of credit unions should be the company tax rate, presently 33%; and
- e taxation of the income of all credit unions apply from the income year commencing 1 April 1990.

## CHAPTER 2 - THE TAX TREATMENT OF LIFE INSURANCE COMPANIES

### 2.1 Introduction

In the current financial services market, there is a continuing blurring of the dividing lines which used to delineate sharply the activities of banks, life offices and other financial organisations. In this environment, the continuation of a special tax structure for any one particular form of business entity may of itself either penalise or encourage the development of that type of entity. Life insurance is subject to a special tax regime. The review of the taxation of life insurance is thus part of the Government's programme of tax reform.

Accordingly, the Government produced a Consultative Document in March 1988 setting out a proposal for a new, comprehensive tax base for life insurance. This chapter reviews that proposal, considers the comments made in submissions and sets out the Committee's recommendations.

Other issues relating to life insurance, namely the separation of the life insurance and superannuation business of life offices and the treatment of premiums and claims in the hands of policyholders, are discussed in chapters 3 and 4.

The Committee considered four main options for taxing life insurance companies. The first two originated from the Consultative Document and are discussed in the next section. A further two options were developed by the Committee - these are discussed in section 2.4.

### Definition of Terms

It is helpful first to define some variables to be used to describe and discuss the options.

C	= claims paid during the year including cash bonuses
V <sub>0</sub>	= actuarial reserve at the beginning of the year
V <sub>1</sub>	= actuarial reserve at the end of the year
I	= investment income
E	= total revenue expenses (including investment expenses)
E <sub>I</sub>	= investment expenses
P <sub>I</sub>	= premiums received during the year
U	= gross underwriting income
F	= financial intermediation fee charged by the life office
T	= net investment income transferred to proprietors or retained as capital
c	= company tax rate
p	= tax rate based on personal tax rates.

## 2.2 Options Proposed in the Consultative Document

### a CD Option 1 (CD's preferred option)

This is the option set out in Chapter 2 of the Consultative Document. It involved the following tax bases and rates.

For proprietors:

Tax base =  $U + F - E + E_I + T$ ; tax rate =  $c$ .

For policyholders:

Tax base =  $I - E_I - F - T$ ; tax rate =  $p$ .

The CD proposed that underwriting income,  $U$ , be calculated as:

$$U = P - C,$$

and that a special withholding tax be applied to premiums as they were received by the life office. It was acknowledged that this approach resulted in the savings component of premiums being taxed but with an offsetting deduction when claims were paid out. However, the approach had the attraction of avoiding the need to base the tax payable on changes in actuarial reserves, which were dependent on forecasts of future events including future deaths, investment returns and expenses. The CD also argued that the approach would not create any significant problems provided tax rates remained fairly constant over time and life offices were able to carry losses back into earlier years.

### b CD Option 2

This option was set out in Chapter 3 of the Consultative Document and involved improving on the existing system without departing from its basic structure. Thus the life office would continue to be taxed only as a proxy for policyholders and the tax basis would remain as investment income less investment expenditure. However some minor amendments were proposed to clarify some aspects of existing legislation.

## 2.3 Submissions Received

In comparison with the 225 submissions received on superannuation, the submissions on life insurance were modest in number, but not in technical content. A total of 18 submissions were received:

Life Offices	11
Trade and Professional Associations	3
Actuaries and Consultants	4

We met initially with the following:

AMP Society  
Life Offices Association  
National Mutual  
N.Z. Society of Actuaries

and continued the consultative process with the Life Offices Association (as the body representing the life insurance industry) and the N.Z. Society of Actuaries.

The submissions to the Committee agreed that:

- (a) life offices should be taxed on a basis which replicates that of other taxpayers; and
- (b) life offices should pay tax as a proxy for the policyholders in respect of the net income distributed to policyholders.

The life offices also regarded section 204 of the Income Tax Act - which sets out part of the regime for life offices - as being in need of substantial revision.

#### Comments Made on CD Option 1

With respect to the CD's Option 1, the majority of submissions argued against the use of two separate bases. It was suggested that the difference between the tax rates to apply to the two tax bases would be small enough to permit the bases to be amalgamated, leading to an overall tax base of:

$$I - E + U$$

Other arguments advanced against the use of two separate bases included:

- that the apportionment of the various items would be difficult;
- that investment income retained as capital can be used for the benefit of policyholders as well as shareholders; and
- that some part of the underwriting income may be distributed to policyholders.

The submissions were strongly opposed to the suggested method of calculating underwriting income, ie  $U = P - C$ . The reasons advanced related mainly to the timing difference between the assessability of premiums and the deductibility of associated claims. It was argued that this timing difference:

- is not in accord with Statements of Standard Accounting Practice No 1 and No 9;
- is against normal tax rules;
- requires life offices partially to fund benefits out of future tax deductions, effectively making the Inland Revenue Department the principal reinsurer of life business;

- would lead to problems if tax rates change;
- would inhibit new entrants to the life insurance industry;
- would encourage aggressive tax planning; and
- would enable Government to compulsorily "borrow" from life offices.

Some submissions argued that underwriting income should instead be calculated as:

$$U = q_1 S - C \quad \text{or} \quad q_2 (S - V_0) - \sum_{\text{claims}} (C_i - V_{0_i})$$

where

$q_1$  = mortality factors from the NZ Life Tables published by the Department of Statistics

$q_2$  = mortality factors used in the calculation of  $V_0$

$S$  = sum of the amounts payable on death under current policies.

Others considered that the operations of the life insurance industry are based on the use of actuarial methods and reserves and that a life office tax regime which does not recognise this would likely be inequitable.

#### The Committee's Views

The Committee rejected the proposal put forward in submissions to amalgamate the two bases to give a total base of  $I - E + U$ . Amalgamation would allow losses incurred by the life office to be offset against income distributed to policyholders and vice versa. Where a company makes a tax loss, its shareholders are not able to use that loss to reduce their tax liability on income from other sources. Although companies are sometimes able to utilise losses by grouping with other taxpaying companies, allowing an offset with policyholder income in the life insurance regime would give life offices and their policyholders an advantage over other taxpayers.

The Committee also rejected the alternative formulations of underwriting income as:

$$U = q_1 S - C \quad \text{or} \quad q_2 (S - V_0) - \sum_{\text{claims}} (C_i - V_{0_i}).$$

We felt that, while the proposed formulations provided a reasonably accurate method of calculating the profits/losses arising from mortality, they made an inadequate allowance for income arising from management fees and no allowance for profits from other areas, eg profits made on surrenders.

The Committee considered that the CD's preferred option had three significant advantages. First, it provided a comprehensive tax base which would allow life offices to come within the imputation system for shareholder taxation. Second, it avoided the need for actuarial calculations and was therefore simple. Third, it

effectively limited scope for manipulation.

However, against these advantages, the Committee agreed with submissions that the taxation of the savings element of premiums with an offsetting deduction for claims would create problems. In particular, the Committee considered that the proposal would result in an inappropriate tax treatment for companies with changing levels of business, ie companies that were growing or contracting. For example, a company that was growing would generally face a higher initial tax bill relative to a company with a constant level of business. The Committee was also concerned that the proposed method was too heavily reliant on tax rates remaining constant over time. This seemed to be an unrealistic assumption given the long time periods involved with life insurance and recent experience with respect to tax rates. Finally, it was considered that the CD was correct in suggesting that the transition from the existing regime to the proposed one would be very difficult. The Committee felt that these drawbacks were significant and that other alternatives should be examined.

With regard to the use of actuarial reserves, the Committee:

- notes that the Income Tax Act contains examples of the use of judgemental bases to determine the taxable profit of a taxpayer;
- notes that actuarial estimates conform with commercially acceptable practice and are prepared by professionally qualified experienced individuals.

The Committee regarded the CD's Option 2 as a fall-back option, to be used only in the event that alternative, more comprehensive, tax bases proved unworkable. We have concluded that workable, comprehensive options are available and that these are to be preferred even though they are somewhat more complex than the current basis.

The Committee has concluded that the existing life insurance taxation regime as set out in section 204 of the Income Tax Act 1976 is deficient in a number of respects. Any replacement regime should seek to place life offices in a broadly equivalent tax position to other taxpaying entities operating in similar businesses. Generally, we see this as replicating for life offices the taxation regime applying to companies in the insurance and financial sector.

Nevertheless, rules specific to life offices are necessary to take into account aspects of life insurance which do not frequently arise elsewhere. First, holders of participating life policies stand, in many respects, in a position similar to equity owners of companies while in other respects being customers of the life office. Secondly, the liabilities assumed by life offices (and thus also their asset portfolio) tend to be especially long-term.



These principles have led us to the view that the proxy system under which life offices are taxed on behalf of policyholders (rather than policyholders being individually taxed on income derived on their behalf) should be retained. However, we have concluded that, in order to apply normal tax rules to life offices, the rules set down in section 204 of the Act would require considerable amendment.

## 2.4 Further Options Considered by the Committee

### 2.4.1 The Committee's Option 1

The first option developed by the Committee is based on the CD Option 1, but brings actuarial reserves into the formulation of the two tax bases to try to overcome the timing problems inherent in the CD option. The tax bases under this option are as follows.

For proprietors:

Tax base =  $P + I - E - C - (V1 - V0) - \text{policyholder tax}$ ;  
tax rate =  $c$ ;

For policyholders:

Tax base =  $[C + (V1 - V0) - (P - U)] / (1 - p)$ ; tax rate =  $p$ .

The Committee's proposed definition of underwriting income is given in section 2.5 below and the basis of calculation of actuarial reserves for tax purposes is discussed in section 2.6.

The Committee considers that the current top personal tax rate of 33% is the appropriate rate to reflect the effective marginal tax rate of individuals investing in life insurance. Data from the 1987/88 Household Income and Expenditure Survey indicates that 57% of expenditure on life insurance is incurred by individuals with a tax rate of 33% or higher. The 33% rate is also consistent with the rate applying to Category 2 and 3 superannuation schemes as well as trusts in general.

The proprietors' tax base makes all income assessable, including premiums, but provides a deduction for income distributed to policyholders, including the tax paid on their behalf, and additions to the actuarial or prudential reserves. The base would be taxed at the company rate and the life office would be able to distribute tax credits to its shareholders in the same way as other companies. It would not, however, be able to use tax losses to offset policyholder tax.

The policyholder tax base measures the investment income distributed to policyholders by the life office. Since the life office pays tax as a proxy for individual policyholders, the income distributed to them in claims and additions to the actuarial reserve is net of tax. This means that, if the

policyholder tax rate is 33%, then for each \$67 distributed to policyholders, \$33 must be paid by the life office in policyholder tax. To achieve this result the policyholder tax base includes division by a gross-up factor of  $1 - p$ .

In calculating the investment returns to policyholders, underwriting income is subtracted from premiums. This ensures that policyholders are not allowed a deduction for the private cost of taking out life cover (just as they are not allowed tax deductions for the purchase of other goods and services for private consumption). At the same time, policyholders will not be assessed on any component of claims that relates to the risk spreading function of the life office.

Assuming for the moment that both tax bases are positive, and setting  $c$  and  $p$  equal to 33%, the total tax payable by the life office will be:

$$\text{Total tax} = 0.33(I + U - E) \quad (1)$$

If either tax base is negative, the tax liability will be greater than this expression (for fixed  $I$ ,  $U$  and  $E$ ), but this additional tax will be offset in future years as losses are carried forward.

As an alternative to carrying losses forward, the life office could try to prevent a tax loss on the policyholder side by increasing the transfer to reserves in that year. A loss on the life office side could be offset in the current year by grouping with another company that had a suitably large tax bill. In most cases then, the tax liability under Option 1 would be as set out at (1) above.

An example of how the tax liability of a life office would be calculated under Option 1 is given below.

#### Example

Suppose	$I =$	100	$C =$	60
	$E =$	40	$P =$	110
	$U =$	20	$c =$	0.33
	$V1 - V0 =$	80	$p =$	0.33

Policyholders' Base:  $[60 + 80 - (110 - 20)]/0.67 = 74.63$

Tax on Policyholders' Base:  $0.33 \times 74.63 = 24.63$

Life Office Base:  $110 + 100 - 40 - 60 - 80 - 24.63 = 5.37$

Tax on Life Office Base:  $0.33 \times 5.37 = 1.77$

Total Tax Payable:  $1.77 + 24.63 = 26.40$

Since both bases are positive in this example, the tax liability can also be expressed as follows:

$$\begin{aligned}
 \text{Total Tax Payable} &= 0.33(I + U - E) \\
 &= 0.33(100 + 20 - 40) \\
 &= 26.40
 \end{aligned}$$

#### 2.4.2 The Committee's Option 2

##### General approach

The Committee's second option adopts an approach which is analogous to the tax imputation system applying to companies. Under the imputation system, a company is taxed as a proxy for its shareholders. The company is then able to attach tax credits to its distributions to shareholders. Shareholders are taxed on the distributions inclusive of the tax credits, but are able to use the tax credits to reduce their personal tax liability.

Under the Committee's Option 2, both the shareholders and the policyholders are treated like the shareholders of ordinary companies. Thus, the first tier of life office tax involves levying the company tax on profits attributable to shareholders as well as investment income attributable to policyholders. Life office shareholders are then able to receive tax credits in respect of distributions made to them by the life office - exactly like the shareholders of other companies.

A similar process occurs with respect to policyholders. During the income year the life office will distribute some of its income to its actuarial reserves for policyholders and some will be distributed directly to policyholders in claims. Since individual policyholders are not taxed on income distributed to them, the policyholder tax must be deducted by the life office before the income is distributed.

If the policyholder tax rate is 33%, then for each \$67 distributed to policyholders, \$33 must be paid by the life office in policyholder tax. However, the life office will have paid tax at 33% on the life office tax base and some or all of this can be used to offset policyholder tax.

Tables which illustrate the approach are set out in Appendix 2.1.

##### The tax bases

Under the Committee's second option, the tax bases are as follows, where underwriting income, U, is defined in section 2.5 below, and the definition of actuarial reserves, V0 and V1, is given in section 2.6.

For the life office:

Tax base =  $I + U - E$ ; tax rate =  $c$ .

For policyholders:

Tax base =  $[C + (V_1 - V_0) - (P - U)] / (1 - p)$ ; tax rate =  $p$ .

The life office base is modelled on the company income tax base. It includes both sources of life office income, ie investment income and underwriting income, with all expenses being deductible. As for other companies, unrealised capital gains are not included as assessable income. Shareholders would be treated like shareholders of other companies. The life office would be able to distribute tax credits with dividends and taxable bonus issues and these would be used by New Zealand resident individual shareholders to offset their personal tax liabilities.

The policyholder base is identical to that in the Committee's Option 1. It includes the investment income attributed to policyholders and eventually paid out in claims. As in Option 1, the net income is grossed-up by dividing by the factor  $(1 - p)$  and the tax rate  $p$  is applied. However, unlike Option 1, the life office can distribute tax credits to policyholders thus offsetting the policyholder liability.

Assuming that the life office uses its tax credits to offset as much of the policyholder liability as possible, the total tax payable under Option 2 will be the greater of the tax calculated on the life office base and the tax calculated on the policyholder base.

It should be noted that even though unrealised gains are not included in the life office base, such gains may be reflected in distributions to shareholders and/or policyholders. Any distributions of unrealised gains will be taxable either as part of the policyholder tax base, or in the hands of shareholders.

An example of how tax would be calculated under Option 2 is given below.

#### Example

Suppose	$I =$	100	$C =$	60
	$E =$	40	$P =$	110
	$U =$	20	$c =$	0.33
	$V_1 - V_0 =$	80	$p =$	0.33

Life Office Base:  $100 + 20 - 40 = 80$

Tax on Life Office Base:  $0.33 \times 80 = 26.40$

Policyholders' Base:  $[60 + 80 - (110 - 20)] / 0.67 = 74.63$

Tax on Policyholders' Base:  $0.33 \times 74.63 = 24.63$

Total Tax Payable: 26.40

In this example, the life office has used 24.63 of tax credits to offset the policyholder tax liability. In fact the life office might hold back some of these credits for distribution to shareholders. It would then pay tax in excess of 26.40.

## 2.5 Definition of Underwriting Income, U

The Committee is using the term "underwriting income" to mean the income earned by the life office in respect of the risk-spreading service it performs for policyholders. It includes three elements:

- mortality profit (M) which arises when the deaths experience of the office during the year is more favourable than expected;
- a premium loading (PL) to pay for the risk-spreading service and generate a profit; and
- discontinuance profits (D) made on policies discontinued during the year.

The Committee proposes to define these three elements as set out below. Note that "year" refers to a company's accounting year.

### **Mortality profit:**

$$M = \sum_{\substack{\text{all} \\ \text{policies}}} q_i (S_i - V0_i) - \sum_{\substack{\text{deaths} \\ \text{during} \\ \text{year}}} (S_i - V0_i)$$

### **Premium loading:**

$$PL = 0.2 \sum_{\substack{\text{all} \\ \text{policies}}} q_i (S_i' - V0_i)$$

### **Discontinuance profit:**

$$D = \sum_{\substack{\text{surrenders} \\ \text{and lapses} \\ \text{during year}}} (V0_i + P_i - SV_i)$$

where  $q_i$  = probability of death claim under policy i during the year

$V0_i$  = amount in actuarial reserve for policy i at the beginning of the year

$P_i$  = premiums paid on policy  $i$  during the year

$SV_i$  = amount paid on termination of policy  $i$ , prior to deduction of any debts, loans or advances against the security of the policy

and, for life insurance:

$S_i = S_i'$  = amount payable on death under policy  $i$  at the beginning of the year, prior to deduction of any debts, loans or advances against the security of the policy

for annuities:

$S_i = 0$

$S_i'$  = life expectancy of annuitant  $\times$  annual amount of the annuity

The factor 0.2 in the definition of the premium loading has been determined by reference to published Tables of Mortality, reinsurance premium rates and life office temporary insurance premium rates. It is necessarily an approximation, but has been accepted in discussions with representatives of the life offices.

In the definition of discontinuance profit (D), "surrenders and lapses" includes all policies which terminated during the year except where the termination was caused by the death of the life insured, or the survival of the life insured to the end of the term of the policy.

Adding the three elements of underwriting income and simplifying gives, for life insurance:

$$U = 1.2 \sum_{\substack{\text{all} \\ \text{policies}}} q_i (S_i - V0_i) - \sum_{\substack{\text{deaths} \\ \text{during} \\ \text{year}}} (S_i - V0_i) + \sum_{\substack{\text{surrenders} \\ \text{and lapses} \\ \text{during year}}} (V0_i + P_i - SV_i)$$

and for annuities:

$$U = \sum_{\substack{\text{deaths} \\ \text{during} \\ \text{year}}} V0_i - \sum_{\substack{\text{all} \\ \text{policies}}} q_i V0_i + 0.2 \sum_{\substack{\text{all} \\ \text{policies}}} q_i (S_i' - V0_i) \\ + \sum_{\substack{\text{surrenders} \\ \text{and lapses} \\ \text{during year}}} (V0_i + P_i - SV_i)$$

The Committee proposes that the mortality factors,  $q_i$ , in the definition, be the same as those used to calculate the actuarial reserves,  $V0$  and  $V1$ .

## 2.6 Basis of Calculation of Actuarial Reserves

The Committee considered five alternative methods for calculating actuarial reserves for tax purposes.

### a Basis used to calculate premiums

The Committee considered that, under Committee Option 1, actuarial reserves calculated on this basis would produce a tax base which closely approximated the profit actually being made by the office, and that the scope to manipulate reserves to minimise tax would be limited. However, it was stated to us that the basis of calculation of premiums of old policies would not currently be known to many life offices. The Committee therefore rejected this option.

### b Surrender values

Under this option the actuarial reserve, for tax purposes, would contain only the surrender values of policies in force. This option was considered because it may be argued that, prior to making a claim, a policyholder's income from a policy is simply any increase in surrender value. However, the Committee rejected this argument. We considered that policyholder income was accruing over the term of the policy and that this would not be adequately reflected in changes in the surrender value. The Committee also felt that this option might encourage life offices to alter their practices in relation to the setting of surrender values. Tax-induced behaviour of this sort is inefficient; it also erodes the tax base.

### c Published return required under the Life Insurance Act

Under this option life offices would calculate their actuarial reserves, for tax purposes, using the same assumptions as were used in the return required under the Life Insurance Act. This return is made to the Justice Department at least once every three years, published, and is forwarded by the Justice Department to the Government Actuary for comment. An actuary nominated by the company would be required to certify that this basis had indeed been used, and to list the assumptions.

The Committee felt that this option had the advantage of using existing procedures and being based on published material. However, it was considered that this method could allow significant scope for manipulation. It seemed likely that the incentive to minimise tax would lead life offices to change the basis of calculation of reserves for the purposes of the published return. The Inland Revenue Department would then have difficulty challenging such calculations since the life office could readily argue that the reserves were indeed consistent with the reserves prepared for the purposes of the return to the Justice Department. The Committee felt that it was essential for Inland Revenue to be able to challenge the

basis on which tax returns are prepared. Accordingly, this option was rejected.

**d Statutory basis**

Under this option, the financial and demographic factors to be used in the calculation of the actuarial reserves, and the method of calculation of the actuarial reserves, would be specified in the Act.

The Committee rejected this option for the following reasons:

- the Committee considered that one set of financial and demographic factors would not be appropriate for all life offices; and that such parameters would need to be kept under review so that they did not become out of date;
- the Committee felt that this option could inhibit the development of new life insurance products and thus tend to restrict competition between life offices;
- the Committee felt that such a basis might come to be regarded as setting a minimum solvency standard for life offices, thereby inhibiting the distribution of profits to policyholders and shareholders, thus restricting competition between life offices and other financial institutions.

**e Basis determined by the life office and acceptable to the Commissioner**

After considering the four options set out above, the Committee concluded that the best method of calculating reserves for tax purposes was the method actually used by the life office to give a realistic assessment of the life office's financial position. Any other method would either be too inflexible to deal adequately with a wide range of products and life office clientele, or allow an unacceptable degree of manipulation.

Accordingly, the Committee proposes that the reserves should be calculated on a basis determined by the life office's actuary, using interest, mortality, and other assumptions that are:

- reasonable in the light of the life office's experience;
- consistent with the basis used by the life office's actuary in making recommendations on the level of surplus available for distribution to shareholders and/or policyholders; and
- acceptable to the Commissioner of Inland Revenue.

In addition, the Committee proposes that:

- in the first year of operation of the new regime, V0 and V1 must be calculated using the same assumptions; and



- the initial and final reserves,  $V_0$  and  $V_1$ , in respect of each policy should be non-negative and no less than the surrender value of that policy at the beginning and end of the year respectively.

The requirement that  $V_0$  and  $V_1$  be positive would limit the ability of a life office to claim a double deduction for expenses such as commission fees. That is because such expenses are likely to be the main reason for reserves being negative.

Finally, the Committee proposes that the life office's actuary be required to sign the tax return stating the assumptions used in the preparation of the return and certifying that the calculations and assumptions meet these criteria (except for acceptability to the Commissioner of Inland Revenue).

## 2.7 Scope for Manipulation

The Committee is concerned that the life insurance tax base should not put in place incentives for life offices to alter their business practices. In particular, it should not encourage life offices to act imprudently in order to minimise tax. Nor should the tax basis open up avoidance opportunities which would allow the tax base to be eroded.

The potential for manipulation of the tax bases put forward as Options 1 and 2 above will come principally from the calculation of actuarial reserves. This scope will be limited by the requirement that the final reserve,  $V_1$ , for a particular policy in a particular year will become the initial reserve,  $V_0$ , in the following year. It is also proposed that both  $V_0$  and  $V_1$  must be non-negative for each policy in each year.

However, the method the Committee has proposed for calculating reserves will not eliminate the possibility of manipulation. It is therefore important to consider how the behaviour of life offices and the amount of tax revenue raised would be affected if life offices were to calculate reserves in a tax-effective way. This is done in Appendix 2.2.

The analysis shows that, while Option 1 would appear to raise more revenue in some cases, this relies on the assumption that life offices cannot utilise tax losses in the year they arise. In fact, it seems likely that losses could often be utilised with the result that the revenue collected under Option 1 would be lower than under Option 2.

The Committee considers that under Option 1, the proprietors' tax base could be made to be negative. This could arise from the life offices' current practice of distributing unrealised gains to claimants, thus inflating "C" with no corresponding increase in "I". The proprietors' tax loss could then be used, for example by grouping with another company, to offset the tax on unrealised gains distributed to policyholders.

The Committee concludes that Option 2 offers less scope for manipulation than Option 1. Option 2 could therefore be expected to have less influence on business practices.

## 2.8 Treatment of Unrealised Capital Gains

The Committee has consulted the Life Office's Association on the two new options that we have considered. The main policy issue raised by the Association was the appropriate definition of "policyholder distributions". Under both options, "policyholder distributions" are effectively defined in terms of policy claims plus any increase over the year in the life office's actuarial reserve, less premiums.

As the Association pointed out, those deemed distributions could be funded in part from "unrealised capital gains". The Association stated its opposition to this aspect on the following grounds:

- a it would impose an "unrealised capital gains tax" which would be contrary to accepted income tax principles;
- b other entities are not faced with this form of tax impost; and
- c the analogy with distributions is inaccurate in that companies would not normally make distributions from this source. If they were to do so, that could be effected by way of non-taxable bonus issues which would not incur a tax liability.

The Committee regarded this issue as being of considerable importance and therefore carefully re-considered the Option 2 proposal in the light of the Association's concerns. As noted above, our concern is to put forward a life office taxation regime which is compatible with the regimes applying to other entities but which meets the particular circumstances of life insurance.

The Committee's approach therefore needs to be justified on the grounds that it appropriately taxes distributions along the same lines as distributions made from other entities. Having considered this issue again, the Committee remains of the view that the approach can be justified on that basis. Although it would tax capital gains, realised or unrealised, on distribution, those are the taxation rules which also generally apply to ordinary companies. Whether a distribution from any particular source is or is not prudent is a matter which should be determined by shareholders subject to company law requirements.

We have concluded that an increase in an office's actuarial reserves is the closest possible approximation to normal corporate distributions. The closest analogy is to a taxable bonus issue. A company making a taxable bonus issue transfers income to shareholder capital. That is then taxable to shareholders as a deemed distribution with possible offsetting imputation credits.

The increased shareholder capital is then distributable in cash, subject to certain restrictions, tax-free. Similarly, under Options 1 and 2, an increase in a life office's actuarial reserves would be deemed a distribution which would be taxable. Under Option 2 the tax on the distribution could be offset by any available imputation credits. The amount in reserves would then be distributable to policyholders effectively tax-free.

Non-taxable bonus issues, on the other hand, are not analogous. For taxation purposes, a non-taxable bonus issue does not increase shareholder capital and thus does not increase the amount which a company can distribute to shareholders free of tax.

A second reason for defining policyholder distributions in terms of an increase in a life office's reserves is the long-term nature of life office business and the adoption of the proxy basis for the taxation of life offices. Those aspects allow a life office to provide returns to policyholders on the basis of any accrued increase in the value of investment assets while meeting claims (payable to policyholders tax-free) from other cash sources. Thus, if policyholder deemed distributions excluded any aspect of accrued investment gains, the tax on such gains could be indefinitely deferred even though they could still give rise to cash distributions to policyholders. That would not produce a position whereby life offices were subject to a taxation regime compatible with the regime faced by similar entities.

## 2.9 Proposed Basis of Taxation for Life Insurance Companies

The Committee recommends that life offices be subject to the Committee's Option 2 regime which integrates the proxy and normal company imputation systems. That would result in life offices being taxed first on their own account. The tax base would be full income of the life office (not just investment income as at present). The aim is to replicate the type of tax regime which applies to the income of other entities such as general insurance companies. That means there would be no specific restrictions on expense deductibility over and above those imposed under ordinary taxation law.

The recommended regime would impose a second level of tax on life offices. That is aimed at reflecting the integration of the proxy and imputation systems. Life offices would be taxed on distributions made to policyholders in the same manner that equity holders of normal companies are taxed on dividend distributions which they receive. As is the case with dividends, life offices would be able to offset this second level of tax by imputation credits to the extent to which tax has already been paid at the first level.

We appreciate that the regime we are proposing may produce some competitive difficulties for life offices with respect to some products which have a significant investment component and a far less significant insurance element. That reflects the fact that

the proposed life insurance regime is designed to accommodate the requirements of taxing pure life insurance. After much investigation, we have concluded that no system perfectly accommodates all forms of pure life insurance and investment.

### 2.9.1 Deductible expenditure

The Committee's proposed tax base incorporates underwriting as well as investment income. Accordingly, there is no reason to restrict deductible expenditure to investment related expenses. The Committee proposes that, in relation to the deductibility of expenditure, life offices be subject to general tax law.

### 2.9.2 Capital gains

At present, life offices are taxed on all realised capital gains under a specific provision in section 204 of the Act.

The Committee considered the case for removing the specific provision for taxing life offices on realised capital gains and instead applying general tax law. In the Committee's view, this would not change the effect of the law but simply bring the legislation relating to life offices into line with that applying to other industries involved in investment, eg banks and other insurers.

However, since the Government has signalled its intention to include a wider range of capital gains in the tax base, the Committee considered it would be inappropriate to remove the current section 204 provision. Accordingly, the Committee proposes that the current law relating to the tax treatment of capital gains realised by life offices be carried over to the new regime.

### 2.9.3 Dividends received by life offices

Under the present tax regime for life offices, dividends are taxable to the life office as part of investment income. Life offices are, however, able to receive tax credits from the companies in which they hold shares to reduce the tax due in respect of the dividends.

Under the regime the Committee is proposing, the treatment of dividends in the hands of life offices can be more closely aligned with the treatment applying to other companies and their shareholders.

As for other companies, the section 63 intercorporate dividend exemption will apply and so investment income, I, in the life office tax base will not include dividend income. However, to the extent that such dividends are distributed to policyholders, they will be reflected in the policyholder tax base and taxed accordingly. Any credits attached to dividends received by the life office will be available to be passed on to life office

shareholders or to offset policyholder tax.

#### 2.9.4 Proprietary and mutual companies

In general, the income tax system should try to avoid influencing the institutional form in which businesses are conducted. As noted in the Consultative Document, life offices are usually of one of two types: proprietary companies or mutual companies. A proprietary company is owned by ordinary shareholders who, as a class, are separate from policyholders. A mutual company, on the other hand, is, in effect, owned by policyholders.

Both types of company are active in the New Zealand life insurance market. They operate their businesses along similar lines. The only perceivable differences are in internal organisation (directors of mutual companies are elected by policyholders whereas directors of proprietary companies are elected by shareholders), and in some aspects of internal financial arrangements (with proprietary companies, but not mutuals, shareholders have equity capital at risk whereas mutuals only have policyholder capital at risk). Even the last difference is often more apparent than real. That is because a policyholder's return on premia payments is more often determined by the type of policy held (participating or non-participating) than by the structural organisation of the life office itself.

The differences that do exist between proprietary and mutual offices are, in our view, insufficient to justify any difference in taxation treatment beyond what is made necessary by the different ownership structures. Thus, under the proposed taxation regime, profit distributions to policyholders will be taxed in the hands of the life office as part of the policyholder tax base (irrespective of whether the office is a mutual or proprietary), but distributions to shareholders of a proprietary company will be subject to tax as dividends with imputation credits (where available) in the same manner as any ordinary company distribution to shareholders.

This neutral treatment of mutual and proprietary companies was supported in the submissions we received. In particular, submissions objected to the proposals in the Consultative Document that mutual companies be subject to special tax treatment to prevent them from offering policies with low premiums so as to reduce their tax while providing benefits to policyholders. Under the taxation regime for life insurance we have proposed, such a measure would not be necessary. Any discount on premiums would be reflected as an addition to the policyholder base and taxed accordingly.

#### 2.9.5 Low interest loans to policyholders

Under the tax base that the Committee has proposed, life offices may seek to provide tax-free benefits to policyholders in the form of low interest loans. The government has proposed that a company

providing such loans to shareholders should be subject to FBT on the extent to which the interest rate on loans to shareholders is less than the prescribed rate for FBT purposes. This recognises the fact that such loans are an alternative means of distributing corporate income to shareholders. The Committee proposes that the same regime apply to low interest loans made by life offices to their policyholders.

#### 2.9.6 Grouping provisions and loss carry forwards

The Consultative Document noted that the application of section 191 of the Income Tax Act (which allows the loss of one company in a group of companies to be utilised against the losses in another member of the group subject to meeting certain ownership requirements) with respect to life companies should be reconsidered if life offices were to continue to be taxed as a proxy for policyholders. The submissions we received opposed any change which would restrict the ability of a life office to group its income with other companies which met the normal statutory requirements.

Under our proposed taxation regime for life insurance, the concerns expressed in the Consultative Document and in submissions can both be met. Where a life office does meet the requirements of section 191 of the Act it should be able to group income and losses with the life office tax base. That is because the life office tax base is comparable with the ordinary corporate tax base. The policyholder tax base, on the other hand, is a proxy for tax on distributed income. Companies cannot group the income or losses of shareholders with the income of other companies. The same should apply to life offices. Thus, there should be no ability to group tax on the policyholder tax base with the income or losses of other group companies.

The Consultative Document proposed that a life office be able to carry forward losses under section 188 irrespective of share ownership changes. However, under our proposed taxation regime, tax at the life office and policyholder bases should be accounted for separately. Past losses from one base should not be able to be used to offset income from the other. The continuity of share ownership requirements in section 188 should apply to the carryforward of losses with respect to the life office base but, for the reasons given in the Consultative Document, not with respect to the policyholder base.

This raises a transitional issue with respect to any losses which a life office already has available to carry forward when the new regime comes into place. Should those be available to be carried forward and, if so, against which base? We consider that they should be able to be carried forward and should be carried forward against the policyholder base. That is because the existing tax regime aims to tax life offices purely as a proxy for policyholders. It therefore seems appropriate to allow past losses to be offset against tax to be paid as a proxy for

policyholders.

#### 2.9.7 Reinsurance

Life reinsurance companies should be taxed on the same basis as insurance companies. That is the case at present and should remain under the revised taxation regime. A life re-insurance company would therefore be subject to tax at both the life office and the policyholder (the reinsuree) tax base.

With respect to the reinsuree, P, C, V1, V0 and U in the policyholder tax base should be net of re-insurance but only if the reinsurance is with a company subject to tax in New Zealand. Where tax has been paid at the reinsurance company level on distributions, the method proposed above would avoid a second tax impost on the proceeds of reinsurance policies.

#### 2.9.8 International Aspects

The Consultative Document raised a number of issues with respect to possible international implications of the review of life insurance. At paragraph 2.16 of Volume 2 it reached the view that consideration should be given to deeming the New Zealand business related life funds of non-resident life offices to be New Zealand resident companies. That was stated to be for two reasons:

- a to preserve the tax-free nature of benefits from such life funds in the hands of the beneficiary; and
- b to allow non-resident life funds to be able to utilise imputation credits on the dividends which they receive on behalf of policyholders.

With respect to benefits provided by a life office, the legislation enacted will, from 1 April 1990, exempt from taxation annuities paid by a life office which is subject to New Zealand taxation irrespective of whether or not the office is resident in New Zealand (section 61(59)). With respect to imputation credits, current legislation allows non-resident life insurers to utilise imputation credits. A life office, whether or not resident in New Zealand, is taxed on dividends under section 204 which is in Part IV of the Income Tax Act. Under section 394ZC, total assessable dividend income under Part IV includes any imputation credits attached to dividends. Under sec 394ZE, where assessable dividend income includes imputation credits, a taxpayer is entitled to a tax credit equal to the imputation credits. Thus, since a non-resident life office is taxed on dividends under Part IV of the Act, it is entitled to utilise imputation credits attached to those dividends. The position of lump sum benefits received from a life office (resident or non-resident) remains unchanged. Such benefits are in general tax-free.

Therefore, the reasons advanced in the Consultative Document for taxing non-resident life offices as New Zealand residents with

respect to their New Zealand business do not now apply. However, the existing approach to life office imputation does allow non-resident life offices to repatriate profits to head offices without a New Zealand tax impost which is not the case with other non-resident entities. Moreover, we have recommended changes to the manner in which dividends are to be treated in the hands of a life office. We have recommended that life offices be able to benefit from the section 63 inter-corporate dividend exemption along the same lines as other companies. That exemption does not apply to non-resident corporates receiving dividends. Nevertheless, since the ultimate beneficiaries of the dividends received by a non-resident life office with respect to its New Zealand business will generally be New Zealand policyholders (for whom tax will be paid on distribution as part of the policyholder base), we consider that the section 63 exemption should still apply to non-resident life offices with respect to their New Zealand life insurance business.

For this to apply it would still be necessary to treat the New Zealand branches of non-resident life offices as New Zealand residents. That should be by election of the life office subject to the approval of the Commissioner of Inland Revenue. Any funds, other than investments relating to New Zealand business, flowing between such a branch and the life office's overseas operations should be treated as a transaction with a non-resident entity and should be taxed as if such funds were a dividend, payments under a reinsurance contract, or expenses, as is appropriate.

The Consultative Document also raised the issue of the taxation of income derived by New Zealand resident life offices with respect to life insurance carried on outside of New Zealand. At paragraphs 2.16 and 3.10 of Volume 2 it was stated that this should be considered in the context of international taxation reforms. As an ordinary income tax principle, investment income derived from New Zealand should be subject to tax in all cases. New Zealand resident life offices should be subject to tax in full on income derived from overseas operations as is the case for other New Zealand residents.

However, under the current life office tax regime, life offices are distinguishable from most other taxpayers in that they pay tax on behalf of policyholders rather than in their own right. It was therefore submitted that the taxation of overseas life insurance activity would place New Zealand resident companies at a competitive disadvantage vis a vis overseas offices in foreign markets since it would result in investment income derived from offshore which is ultimately attributable to non-resident policyholders being subject to New Zealand tax. Moreover, New Zealand resident general insurers are not normally taxed on their income from overseas operations.

Consideration should be given to exempting from tax overseas sourced investment income derived with respect to overseas operations which is distributed to non-resident policyholders. In



our view, such income does not have a sufficient connection with New Zealand so as to make it appropriately subject to New Zealand tax. On the other hand, New Zealand sourced investment income should always be subject to New Zealand tax and there is no justifiable reason for not taxing the underwriting income derived by New Zealand resident life offices from their overseas operations. The most feasible means of achieving the suggested tax result would appear to be to deem the overseas branch to be a non-resident entity with underwriting and New Zealand sourced investment income being included in the New Zealand company's life office tax base as CFC income.

#### 2.9.9 Implementation date

The Committee proposes that the new regime apply from the income year commencing 1 April 1990.

#### 2.10 Coverage and Transitional Measures

The Committee is aware of the close association between life insurance and superannuation and the consequent need to ensure that the tax regimes for these types of business are compatible. Superannuation schemes which offer amounts payable on death and pensions payable on survival, and bear the associated life/death risk, are essentially involved in the same business as life offices. To the extent that the activities are the same, superannuation schemes should be taxed in the same way as life offices.

Accordingly, the Committee proposes that the new life insurance regime should apply to all business arising from any contract whereby a person offers benefits contingent on the death or survival of a human life. However, we propose that where a person offering such contracts fully reinsures all life/death risks with some other company, the business should not be classified as life insurance.

The effect of our proposal is to include all superannuation pension business under the life insurance tax regime unless the scheme off-loads all of the life/death risk by, for example, purchasing annuities from life offices. This should ensure that the tax treatment of superannuation and life insurance is consistent and avoid creating incentives for companies to conduct their life insurance business as superannuation or vice versa.

This suggests that life offices should be allowed to transfer assets, without a tax penalty, to a separately identifiable superannuation business which would be taxed under the tax regime applying to superannuation. The Committee's recommendations on these issues are discussed in the next chapter.

## Recommendations

The Committee recommends that:

- a life insurance be subject to the Committee's Option 2 regime which is modelled on the tax imputation system applying to companies and set out in section 2.4.2 above;
- b the tax rate for the life office base be the company tax rate, currently 33%;
- c the tax rate for policyholders be 33% based on the current scale of personal effective marginal tax rates;
- d underwriting income, ie the income earned by a life office in respect of the risk-spreading service it provides, be defined as the sum of mortality profit, a premium loading, and discontinuance profit as set out in section 2.5;
- e actuarial reserves be calculated, for tax purposes, on a basis determined by the life office's actuary, using interest, mortality, and other assumptions that are:
  - reasonable in the light of the life office's experience;
  - consistent with the basis used by the life office's actuary in making recommendations on the level of surplus available for distribution to shareholders and/or policyholders; and
  - acceptable to the Commissioner of Inland Revenue;
- f the deductibility of expenditure incurred by life offices be determined under general tax law;
- g the current law relating to the tax treatment of capital gains realised by life offices be carried over to the new regime;
- h there be no difference in tax treatment for proprietary and mutual companies except what is necessary to take into account a proprietary company's distributions to shareholders;
- i life offices pay FBT on any discounts on interest charged in respect of loans to policyholders;
- j there be no ability to group tax on the policyholder tax base with the income or losses of other group companies;
- k premiums, claims, reserves and underwriting income included in the tax base be net of reinsurance where the reinsurer is subject to New Zealand income tax;
- l by election of the life office and subject to the approval of the Commissioner of Inland Revenue, New Zealand branches of

non-resident life offices be treated as New Zealand residents for tax purposes;

- m consideration be given to exempting from tax, overseas sourced investment income derived with respect to overseas operations which is distributed to non-resident policyholders;
- n the new regime take effect from the income year commencing 1 April 1990;
- o the new life insurance regime should apply to all business arising from any contract whereby a person offers benefits contingent on the death or survival of a human life. However, where a person offering such contracts fully reinsures all life/death risks with some other company, the business should not be classified as life insurance; and
- p life offices be allowed to transfer superannuation liabilities and corresponding assets, without a tax penalty, to a separately identifiable superannuation business which would be taxed under the tax regime applying to superannuation. (The Committee's specific recommendations on this issue are discussed in the next chapter.)

**APPENDIX 2.1 - COMMITTEE'S OPTION 2 (IMPUTATION MODEL)**

This appendix illustrates how the company imputation tax model is applied to life offices under the Committee's Option 2. The first table uses the example of a bank to illustrate the normal company imputation system in conjunction with the tax treatment of the bank's depositors and shareholders. For simplicity it has been assumed that the shareholders and depositors are subject to a marginal tax rate of 33%. The second table illustrates the proposed life office treatment, where the shareholders are again assumed to face a marginal tax rate of 33%.

Table 1 - Tax Treatment of a Bank

<b>Company</b>	
Taxable income	100
Company tax @33%	33
Net dividends	67
<b>Depositors</b>	
Interest	1,000
Personal tax @33%	330
Net income	670
<hr/>	
<b>Shareholders</b>	
a Tax return	
Taxable dividend	100
Personal tax @33%	33
Less tax credits	-33
Tax to pay	0
b Income	
Net dividends	67
Less tax to pay	0
Net income	67
<hr/>	
<b>Total tax paid</b>	
Bank	
- for shareholders	33
Shareholders	0
Depositors	330
Total	363

Table 2 - Proposed Tax Treatment of Life Offices**Company****Life Office Tax Base**

Taxable income	1,100
Company tax @33%	363

**Life Office as Proxy for Policyholders**

a Tax return	
Taxable income	1,000
Personal tax @33%	330
Less tax credits	-330
Tax to pay	0

b Policyholder Income	
Net income	670

**Shareholders**

a Tax return	
Taxable dividend	100
Personal tax @33%	33
Less tax credits	-33
Tax to pay	0

b Income	
Net dividends	67
Less tax to pay	0
Net income	67

**Total tax paid**

Life Office	
- for shareholders	33
- for policyholders	330
Shareholders	0
Policyholders	0
Total	363

## APPENDIX 2.2 - SCOPE FOR MANIPULATION

The Committee is concerned to ensure that the life insurance tax base offers minimum scope for manipulation by the life office. In particular, it should not put in place incentives for life offices to alter business practices or to act imprudently in order to minimise tax.

Given that the potential for manipulation of the two bases put forward by the Committee will come principally from the expression  $V_1 - V_0$ , it is helpful to consider how the total tax liability of the life office varies as the change in actuarial reserves varies. Expressing the tax as a function of  $V_1 - V_0$  gives the following results which are shown in graph form below. The tax rates to be applied to the life office and the policyholder tax bases are both set at 33%.

### Option 1

Total Tax

$$= 0.33(I + U - E) - .33[C + (V_1 - V_0) - (P - U)]$$

$$\text{if } [C + (V_1 - V_0) - (P - U)]/0.67 \leq 0;$$

$$\text{ie, if } (V_1 - V_0) \leq P - C - U;$$

$$= 0.33(I + U - E)$$

$$\text{if } 0 \leq [C + (V_1 - V_0) - (P - U)]/0.67 \leq I + U - E;$$

$$\text{ie, if } P - C - U \leq (V_1 - V_0) \leq P - C - U + 0.67(I + U - E);$$

$$= 0.33[C + (V_1 - V_0) - (P - U)]/0.67$$

$$\text{if } [C + (V_1 - V_0) - (P - U)]/0.67 \geq I + U - E$$

$$\text{ie, if } (V_1 - V_0) \geq P - C - U + 0.67(I + U - E)$$

The formulae and graph show that additions to the actuarial reserve below a certain level ( $V_1 - V_0 = P - C - U$ ) mean that policyholder tax becomes nil and life office tax increases. This has the same effect as an excess retention tax on the life office in relation to its policyholders. When distributions to the policyholders become large enough to make the proprietors' tax base zero, additional distributions to the reserves will increase the tax above  $I + U - E$ . However, this will only occur if the life office is unable to utilise its tax loss. In this case, the additional tax paid may be offset in future years as the tax loss is utilised.

The Committee's first option therefore appears to provide an incentive to pay tax on the basis:

$$I + U - E$$

by keeping the change in reserves within certain limits. If it was not possible to keep the change in reserves below the upper limit:

$$P - C - U + 0.67(I + U - E),$$

then companies would have an incentive to group with taxpaying companies so that the tax loss on the proprietors' base could be utilised.

There will also be some scope for manipulation of underwriting income,  $U$ . To minimise tax, life offices would tend to wish to maximise  $V_0$  and minimise the  $q_i$ . However, the Committee proposes that each life office use the mortality factors it used to calculate reserves. It would then be more difficult to understate the  $q_i$  (or overstate  $V_0$ ).

### Option 2

Assuming that life office tax credits are applied to achieve the maximum possible offset of policyholder tax, the total tax payable by the life office under Option 2 will be the greater of life office tax and policyholder tax. Where life office tax exceeds policyholder tax, the life office will be able to fully offset policyholder tax and have "spare" tax credits which can be distributed to shareholders.

Expressing the total tax liability as a function of  $(V_1 - V_0)$  gives the following results which are also shown in graph form below.

Total Tax

$$= 0.33(I - E + U)$$

$$\text{if } [C + (V_1 - V_0) - (P - U)] / 0.67 \leq I + U - E$$

$$\text{ie, if } (V_1 - V_0) \leq P - C - U + 0.67(I + U - E);$$

$$= 0.33[C + (V_1 - V_0) - P + U] / 0.67$$

$$\text{if } [C + (V_1 - V_0) - (P - U)] / 0.67 \geq I + U - E$$

$$\text{ie, if } P - C - U + 0.67(I + U - E) \leq (V_1 - V_0).$$

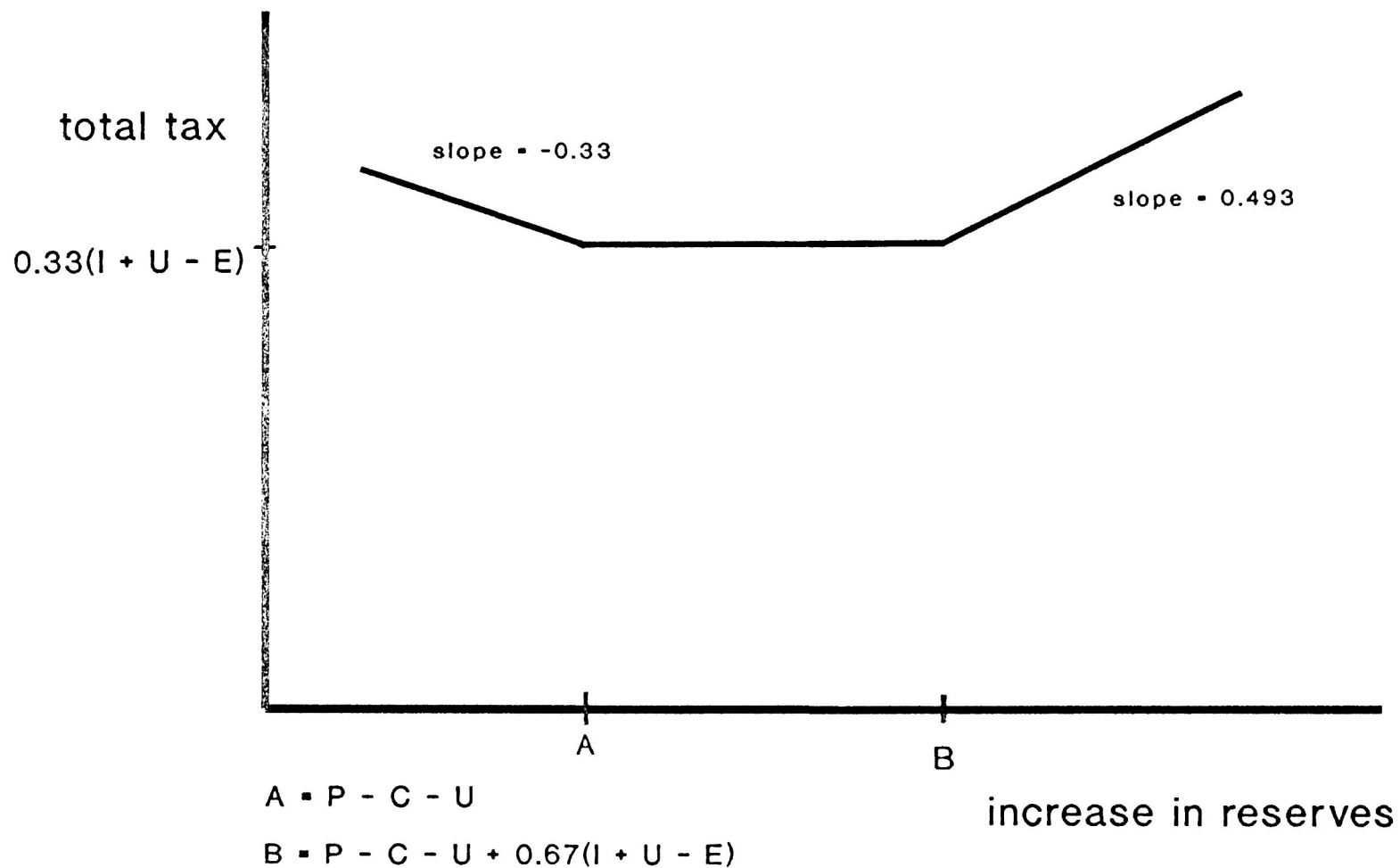
Under Option 2 the only incentive in relation to  $(V_1 - V_0)$  is to keep the increase/decrease in reserves below:

$$P - C - U + 0.67(I + U - E).$$

The scope for manipulation of  $U$  will be the same as under Option 1 and is not considered a significant problem.

# Committee's Option 1

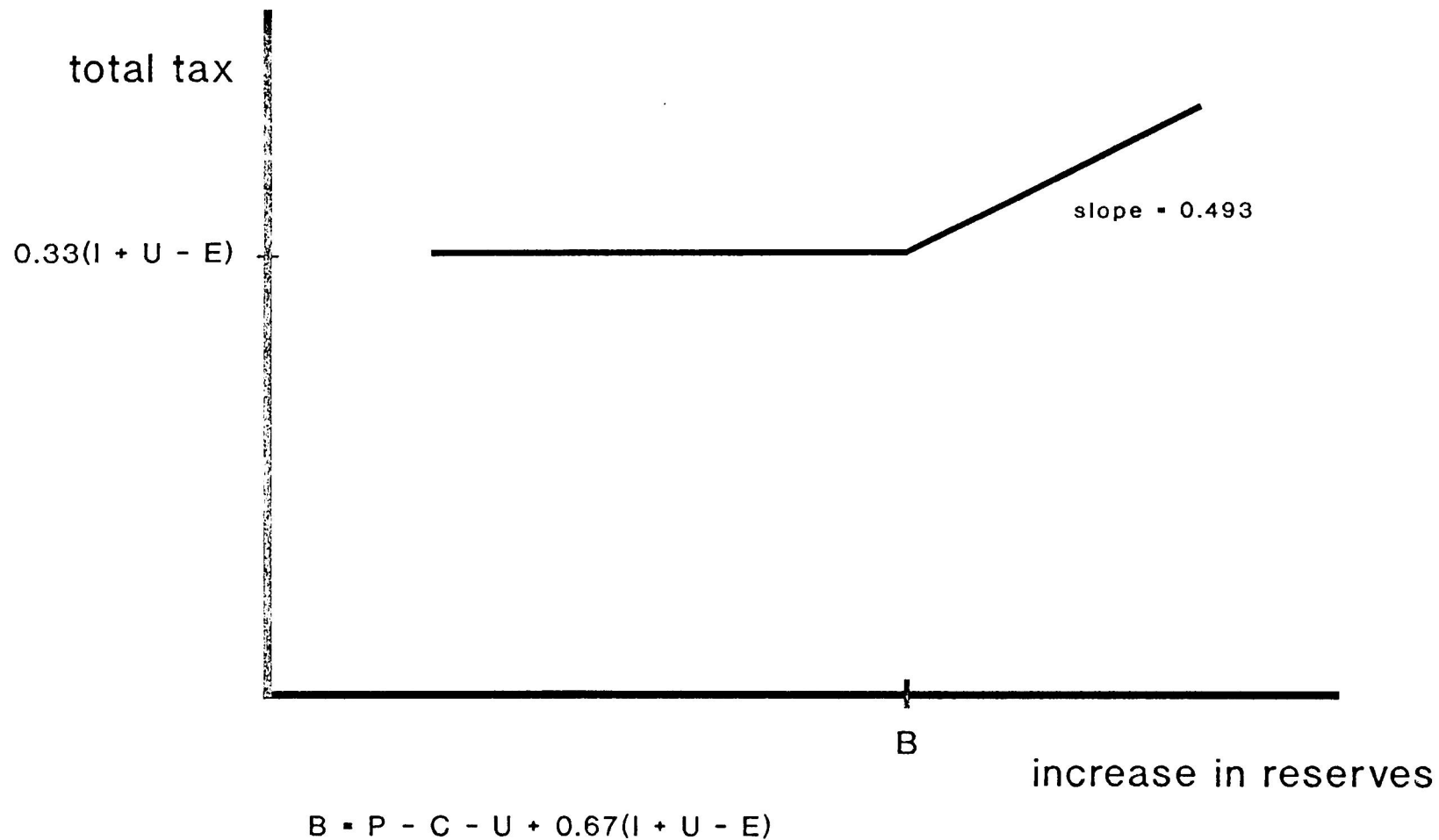
total tax as a function of V1-V0





## Committee's Option 2

total tax as a function of V1-V0



## CHAPTER 3 – THE SEPARATION OF THE LIFE INSURANCE AND SUPERANNUATION BUSINESS OF LIFE INSURANCE COMPANIES

### 3.1 Introduction

As discussed in the previous chapter (section 2.10), the Committee proposes that the new life insurance regime should apply to all business arising from any contract whereby a person offers benefits contingent on the death or survival of a human life. However, we propose that where a person offering such contracts fully reinsures all life/death risks with some other company, the business should not be classified as life insurance.

The Committee considers that, provided the service being offered is essentially the same, superannuation offered by a life office should be subject to the same tax regime as registered superannuation funds. To facilitate this, the Committee proposes that life offices be allowed to transfer assets, without a tax penalty, to a separately identifiable superannuation business which would be taxed under the tax regime applying to superannuation.

The issue of how best to separate the life insurance and superannuation business of life offices has arisen on previous occasions as life offices have sought to benefit from the special tax concessions that used to apply to superannuation. The history of the issue and the Committee's proposals are discussed below.

### 3.2 History

Following representations by the Life Offices Association, the Government announced in the 1983 Budget its intention to amend the Life Insurance Act to enable a life office to establish one or more funds for its superannuation business.

A Joint Working Party of officials from Justice, Inland Revenue and Treasury met on several occasions with representatives of the LOA.

Three alternative approaches to separation were considered in depth:

- (a) separate Statutory Funds
- (b) separate superannuation entities
- (c) sub-accounts within the existing Life Assurance Fund.

Initial discussions indicated that Option (a) would provide the best solution, and the Budget announcement was framed accordingly.

However, detailed investigations showed that the implementation of Option (a) would require widespread legislative changes; and that a corresponding regime was not operating entirely satisfactorily in Australia. Further consideration led the Joint Working Party to favour Option (b), because the separation would be clear-cut and complete, and because the rules for inter-company dealings were already in place; while the LOA preferred Option (c).

The discussions between the Joint Working Party and the LOA were extended to include a fourth option - part of a life office's superannuation business to be treated in the same manner as private superannuation under trustee accounting requirements.

However, no agreement was reached on a permanent long-term solution.

The essential nature of the principal problem was to achieve equitable tax treatment. At that time, this was a matter of identifying the investment income generated in respect of the assets held by the life office for its superannuation business. A subsidiary problem, which is no longer relevant, was to have the same investment ratio requirements for life office superannuation funds as for private superannuation funds.

### 3.3 The Current Position

The solution which was arrived at is embodied in Section 204 of the Income Tax Act. In brief, the total net investment income of a life office is apportioned between "superannuation category 1" business and "all other business" in accordance with the value placed by the life office on its liabilities for those classes of business.

This solution is not regarded as satisfactory by either Inland Revenue or the life offices. The areas of concern relate to both "what should be assessable investment income" and "what should be tax deductible expenses".

### 3.4 Submissions and Subsequent Events

The submissions made by various life offices raised this issue again, and a preference for separate accounting was re-iterated.

Subsequently, the Taxation Reform Bill (No 5) was published. Inter alia, this provided for

- (a) full deductibility of expenses according to normal income tax rules, for superannuation funds not operated by life offices;
- (b) no change in the nature of the expense deductibility permitted to life offices for their superannuation business.

Also, with the agreement of the Minister, the Committee provided the LOA with a draft of the life office tax basis which the Committee recommends to the Minister, in order to reduce uncertainty in relation to expectations arising from the No 5 Tax Bill.

The Committee understands that, in the submissions to the Select Committee on the No 5 Tax Bill, the life offices made a strong plea that they be put in a neutral competitive environment with regard to their superannuation business.

### 3.5 The LOA Position

The LOA has advised the Committee that, to fulfil the "level-playing field" concept espoused by Government, the LOA regards it as essential that life offices be permitted to separate their "life insurance" and "superannuation" business on a permanent basis. The LOA takes the view that this separation is being forced on life offices by Government's changes in the operation of the financial sector.

The LOA has indicated its willingness to move its position from "separate accounting" to a "separate entity" concept provided that certain safeguards are met.

The LOA argues that such a change should not result in the payment of either tax on capital gains or stamp duties when assets are transferred to the entity which will undertake the life office's liabilities under its superannuation business. The LOA states that there should be a time period of 12-18 months during which such separation can take place on these terms at each life office's option. The LOA also wish that the separate entity can operate a pooled investment fund and pay tax on a proxy basis.

### 3.6 Reasons for Separation

The close association between "life insurance" and "superannuation" is part of the historical development of the life insurance industry. The Committee notes that it is a legislative requirement that a life office maintains one "fund" for both types of business (Life Insurance Act 1908, Section 15).

The Committee agrees that the separation of these two classes of business would better enable Government to pursue its initiatives in the superannuation area. In addition, a life insurance policy could then be regarded as just another form of investment (such as equities, debenture stock etc.) available to the trustees of a registered superannuation scheme, thus simplifying the development of future taxation policy.

Accordingly, the Committee accepts that there are good reasons for separating the "life insurance" and "superannuation" business of life offices.

### 3.7 Method of Separation

The Committee considers that "separate accounting" would not provide a satisfactory long-term solution. The practical difficulties experienced overseas would most probably be experienced in New Zealand under any similar regime.

The Committee therefore favours the "separate entity" concept.

The following possibilities were considered:

#### a **Unit trust**

This structure would permit the pooling of funds for investment. Income could be distributed to individual superannuation schemes in the form of taxable dividends which would carry imputation credits. That would provide an income to offset a superannuation scheme's deductible expenses incurred outside the Unit Trust.

However, this structure would not allow for tax to be paid on a proxy basis - the tax basis is that for a company, and not that for a private superannuation scheme. This would create a transition problem, because the corporate tax rate is 33%, and a tax rate of 25% applies to the Category 1 funds of superannuation schemes. In addition, a neutral competitive environment would cease to exist if, at some future date, the corporate and superannuation tax rates were to diverge after having converged.

#### b **Qualifying trust**

This structure would permit the pooling of funds but not the payment of tax on a proxy basis. Also, it would be difficult to establish such a vehicle without bringing it into the income tax definition of unit trust.

#### c **Company**

This alternative suffers from the same disadvantages as a Unit Trust.

#### d **Group investment fund**

This structure may be established by a trustee company pursuant to the Trustee Companies Act 1967.

This structure would permit the pooling of funds for investment and the payment of a tax on a proxy basis. However, because of the limited number of trustee companies and the difficulty of establishing new trustee companies, this type of vehicle would not be generally available to all life offices.

## e Superannuation scheme

The LOA takes the view that the problems previously noted for other structures would disappear if a registered superannuation scheme were able to have other registered superannuation schemes as members: "Pooled funds, tax basis and variations in tax rates would all be taken care of".

The Committee notes that Regulation 10(3)(c) of the Superannuation Schemes Regulations 1983 permits a superannuation scheme which is approved and classified under the Superannuation Schemes Act 1976 to invest in another approved and classified superannuation scheme. This type of investment would not be prohibited by the "prudent person" approach of the Superannuation Schemes Act 1989.

The LOA's wishes can be put into effect if the Superannuation Scheme's Act 1989 Section 2 definitions for "Beneficiary", "Member" and "Superannuation scheme" are subject to a slight alteration to permit registered superannuation schemes to become members of a registered superannuation scheme.

The Committee notes that this approach would enable anyone, including a life office, to enjoy this regime for operating superannuation schemes.

Accordingly, the Committee recommends that this approach be adopted.

### 3.8 Separation - Voluntary or Compulsory?

The Committee considers that each life office should decide whether it wishes to set up a separate vehicle to transact superannuation business (defined as superannuation schemes approved and classified, or registered, by the Government Actuary).

If such an entity is created, the life office can then invite superannuation scheme trustees who are its clients to transfer their scheme from the life office to the entity. This decision can be regarded in the same manner as any investment decision to be made by the trustees.

The Committee is as opposed to giving life offices the authority to make such a transfer without the trustees written agreement as it would be to legislation which compels life offices to transfer their superannuation business to a separate entity.

Once such a transfer is made, it should be irreversible - except to the extent that trustees should continue to have the option of discontinuing the contract and placing their business elsewhere (which could include a replacement contract with any life office).

### 3.9 Separation - Cost

In general, normal tax rules should apply to expenses incurred by a life office in the creation of a separate entity. However, the Committee notes that the creation of a separate vehicle to look after the life office's existing superannuation business would require a transfer of assets to support the transferred liabilities.

This raises questions of:

- (a) tax and duty liability on the transferred assets
- (b) equity between policyholders who remain in the life office and those who transfer to the new superannuation vehicle.

### 3.10 Tax and Duty Liability

The transfer of assets to the new entity could give rise to an income tax liability. In addition, such a transfer can give rise to stamp duty liability.

The Committee is concerned that such transfers of assets should not be unnecessarily inhibited by taxation considerations.

Therefore it seems appropriate to the Committee that a transfer of assets to a new entity should not give rise to any stamp duty or income tax provided that the transfer is made within a reasonably short period of time - prior to 1 April 1991, say. We do not consider that that would reduce Government revenue since if the tax imposts remain, no transfers would take place and no Government revenue would result.

The Committee further considers that, upon the expiry of the time frame for the separation of a life office's "life insurance" and "superannuation" business, all superannuation business which is not transferred out of the life office should be treated as life insurance business for the purpose of taxing the life office.

### 3.11 Equity in Asset Transfer

This question was considered in detail by the Joint Working Party and the LOA in 1983-84.

Whilst a set of guidelines was not defined, there appeared to be general agreement on the following three principles:

- (a) initial separation basis to be actuarially determined and subject to Government Actuary overview;
- (b) identification of assets would need to be justified on the basis of actuarial soundness and life

insurance/superannuation equity;

- (c) any sale of assets between life insurance/superannuation which occurred after the initial separation would be subject to normal commercial practice and involve liability for stamp duty and income tax.

There also appeared to be general agreement on the following methodology:

- 1 identify all assets relating to
  - (i) market-valued life insurance business
  - (ii) market-valued superannuation business
  - (iii) capital guaranteed superannuation business
- 2 apportion the balance of the assets between life insurance and superannuation in proportion to the actuarial liabilities. This separation would be based on market values.

The Committee is in agreement with those principles and that methodology.

Whilst the point does not appear to have been considered by the Joint Working Party or the LOA, the Committee notes that some problems may arise in connection with a large property investment, for example. In such an instance, it may be necessary for the Government Actuary, Inland Revenue, and life office to agree on a percentage apportionment of the investment between the life office and the superannuation entity.

### **Recommendations**

The Committee recommends that:

- a life offices not be inhibited from transferring their superannuation business to a separate entity;
- b the separate entity be a registered superannuation scheme;
- c the Superannuation Schemes Act 1989 be amended to permit a registered superannuation scheme to be a member of another registered superannuation scheme;
- d the transfer of assets to the new entity
  - (i) should be free of stamp duty
  - (ii) should not give rise to income tax liability
  - (iii) should be in accordance with the principles and methodology stated in section 3.11



- (iv) should be completed by 1 April 1991 if  
recommendations d(i) and d(ii) are to apply;
- e any superannuation business remaining in a life office after  
31 March 1991 should be regarded as life insurance business  
for the purpose of taxing the life office.

## CHAPTER 4 - THE TAX TREATMENT OF LIFE AND DISABILITY INSURANCE PREMIUMS AND CLAIMS

### 4.1 Introduction

This chapter considers the income tax treatment of life and disability insurance premiums and claims in the hands of policyholders. It covers "keyperson" policies taken out by employers in respect of key employees, as well as policies taken out by individuals for their own benefit (or the benefit of their families). Disability policies are considered alongside life policies because disability policies often contain a life insurance element.

The chapter proceeds by considering the present tax treatment of premiums and claims in the hands of policyholders and looking at the link between life and disability policies. It then discusses the theoretically correct method of treating insurance premiums and claims, of all kinds, in the hands of policyholders.

Next, the chapter considers whether making a change to the present tax treatment of life and disability premiums and claims would create any boundary problems with other types of insurance. Finally, it addresses any problems that may arise in the transition to a new tax treatment of life and disability policies, and makes recommendations.

### 4.2 Problems with the Present Treatment

#### 4.2.1 The present treatment

Under the present system, life and disability insurance policies are treated differently depending on a variety of factors, including who owns the policy, who benefits from the policy, the form of the benefits, and the essential nature of the insurance contract (eg insurance versus savings).

Term life insurance and disability policies taken out by employers in respect of key employees (for the employer's benefit) are subject to an Exempt/Taxed/Taxed regime. Premiums are deductible, any investment income earned by the insurance company from investing the premiums is assessable, and claims are assessable. Policies of disability insurance taken out by individuals to provide a replacement income are subject to the same treatment.

Most other life and disability insurance policies are subject to a Taxed/Taxed/Exempt regime. Premiums are non-deductible (or deductible and subject to FBT), investment income earned by the insurance company is assessable, and the claims are tax-exempt.

The Committee's understanding of the present treatment of life and disability premiums and claims is set out in more detail in

the Appendix.

#### 4.2.2 The link between life and disability insurance

Disability policies are similar in nature to pure life insurance. Both are taken out to provide financial security, either for the individual, the individual's family, or for the individual's employer, in the face of possible events which curtail income-earning activity. Premiums are therefore incurred to provide compensation in the event of the loss of a capital asset, namely an individual's human capital. Life insurance policies generally provide insurance against premature death, while disability policies insure against disablement. Disability policies usually pay pensions as against the lump sums paid under life insurance. However, the form of the payment should be irrelevant for tax purposes.

#### 4.2.3 Problems with the present treatment

The first problem with the present system is that it seems to lack a consistent basis. The law is somewhat unclear and this has caused difficulty for both taxpayers and Inland Revenue. Another problem arises from the potentially inconsistent treatment of life and disability policies taken out by individuals. Since disability policies may be written so as to contain a life insurance element, these policies could possibly be used to avoid the non-deductibility of life policy premiums.

For those policies subject to an Exempt/Taxed/Taxed regime, the justification for deductibility of premiums has been that the expenditure is incurred in order to earn assessable income. Since it is generally not necessary to take out life or disability insurance to earn current income (although a partnership deed will sometimes require this to be done, for example), the assessable income in question is generally the claim paid on death or disability. However, since it is not at all certain that such income will ever be received by the taxpayer, the link with assessable income in these cases is tenuous.

With respect to term life and disablement insurance policies taken out for the benefit of employers, it may be argued that these policies are similar in nature to general insurance against, say, damage of business premises. Premiums for the latter are currently deductible and it may therefore be suggested that term life and disability insurance premiums should be deductible on the same basis. However, the analysis in the next section suggests that the tax treatment of general insurance may itself be inappropriate.

### 4.3 How Should Insurance Premiums and Claims be Taxed in the Hands of Policyholders?

#### 4.3.1 The theory

Determining the theoretically correct tax treatment of insurance premiums (of all kinds) is complicated by two factors. Firstly, some types of insurance, namely life and disability insurance, may be taken out by an employer for the benefit of that employer or for the benefit of an employee. Employees may also take out life or disability cover themselves. Individuals may take out a life policy for "family protection" purposes, but subsequently assign it to a bank, for example, as security for a loan to be used for business purposes. The difficulty here is the recurrent problem of drawing a line between business and private expenditure.

Secondly, the premium itself is composed of four different elements which, in theory, should be considered separately for tax purposes. The elements are as follows:

- a underwriting fee: this is incurred by the policyholder to pay the insurance company to undertake the risk spreading function;
- b expected loss: this is paid to the insurance company and pooled with amounts paid by other policyholders to be redistributed to those suffering the insured loss;
- c financial intermediation fee: this is incurred to pay for any investment services provided by the insurance company;
- d savings deposit: the amount to be invested by the insurance company and returned to the policyholder with earnings.

The appropriate tax treatment of each of these elements is discussed and then summarised in table form below.

#### i Underwriting fee

When a business takes out fire insurance, for example, it is deciding to buy a risk-spreading service instead of undertaking that risk itself. This appears to be similar to the decision to purchase other goods and services used in the business rather than to manufacture or to provide them within the firm. The cost of purchasing this service should therefore be deductible to the insured and assessable to the insurer where the insurance covers a business-related risk.

In line with the general principle that non-business expenditure is non-deductible, underwriting fees paid in respect of non-business risks should be non-deductible.

An individual who insures against the loss of the individual's own human capital, eg by taking out a disability policy, could be argued to be insuring a business whose assets consist of the individual's human capital. It may therefore be argued that an individual should be able to deduct the underwriting fee. The problem with this argument is that the risk of death or disablement does not arise as a result of being in business, although the level of the risk will vary with the nature of the business (eg top-dressing pilot versus bank clerk). It follows that the underwriting fee should not be deductible to individuals in the circumstances described.

## ii Expected loss

When businesses or individuals take out insurance (of any kind) they are using the insurance company to establish a reserve to meet some of the future contingencies of the policyholders as a group. Other taxpayers achieve the same objective in different ways. For example, producer co-operatives establish reserves for the purpose of stabilising members' incomes. Such reserves are not tax-deductible because they do not represent a reduction in income earned in the year the payment to the reserve is made. Rather, payments to the reserve represent current income that is being set aside or saved to be used at a later date.

When claims are paid out to policyholders who have suffered a loss, there is a transfer of wealth amongst the group of policyholders who have contributed to the reserve. No income is generated by this process. Accordingly, the Committee considers that the expected loss element of the premium should be paid from after-tax income and that claims met from this source should not be assessable. This applies irrespective of who benefits from the policy (ie an individual; an individual's family, business partners or creditors; or an employer) and whether the policy covers business or non-business risks.

## iii Financial intermediation fee

Since this is incurred to earn assessable interest income, it should be deductible to both businesses and individuals.

## iv Savings deposit

Consistent with the normal income tax treatment of savings, this element of the premium should not be deductible to businesses or to individuals. Since the earnings on the savings deposit will have been taxed to the insurance company (which is the intention of the present tax regimes for insurance), the savings deposit plus earnings should be non-assessable when returned to policyholders as claims.

The following table summarises the Committee's conclusions on the theoretically correct treatment of the different components of insurance policy premiums and claims. For completeness, the

third column shows how the element of the premium should be treated in the hands of the insurance company.

### **Tax treatment of insurance premiums and claims**

#### **a Premiums**

<u>Element of premium</u>	<u>treatment in policyholder's hands</u>		<u>treatment in hands of the insurance co</u>
	<u>Private (non-business) risk</u>	<u>Business- related risk</u>	
Underwriting fee	non-deduct	deductible	assessable
Expected loss	non-deduct	non-deduct	non-assess
Financial intermediation fee	deductible	deductible	assessable
Savings deposit	non-deduct	non-deduct	non-assess

#### **b Claims**

<u>Element of claim</u>			
Expected loss	non-assess	non-assess	non-deduct
Savings plus earnings	non-assess	non-assess	non-deduct

The table indicates that the correct treatment of premiums is not clear-cut. This is because some components of the premium should be deductible while others should be non-deductible. However, in the Committee's view, it would be impractical to attempt to differentiate between these elements for tax purposes. The treatment of premiums and claims for policies covering private and business risks are discussed further below.

#### **4.3.2 Policies covering private risks**

In respect of premiums paid to cover private or non-business risks, a fairly strong case can be made for non-deductibility. This is the current treatment of all policies covering private risks except disablement policies providing replacement income. The Committee considers that such premiums should, in theory, be non-deductible. Claims would of course become non-assessable.

#### 4.3.3 Policies covering business-related risks

In respect of premiums paid to cover business-related risks, a case could be made for either a Taxed/Taxed/Exempt or an Exempt/Taxed/Taxed treatment. Three options for dealing with these policies are set out below.

##### a **Premiums deductible, claims assessable**

Under this option both the expected loss and the savings elements of premiums would be deductible. Thus we would have an Exempt/Taxed/Taxed regime for savings set aside to meet future contingencies where this was done through an insurance company. This would run counter to standard income tax treatment. On the positive side, the underwriting and financial intermediation fees would be appropriately treated.

##### b **Premiums non-deductible, claims non-assessable**

This option would give the correct treatment of the expected loss and any savings deposit element of premiums. It would, however, involve a penal treatment of underwriting and intermediation fees which should, in theory, be deductible.

##### c **X% of the premium deductible, claims non-assessable**

This option is intended to approximate the theoretically correct treatment by allowing a deduction for the proportion of the premium charged for underwriting and financial intermediation services. The proportion would probably be fairly small. The same method could potentially be used in the formulation of underwriting income for inclusion in the tax base of life insurance companies.

The main difficulty with this option is that the proportion of the premium made up by underwriting and financial intermediation fees will differ amongst policies. The proportion chosen would therefore be somewhat arbitrary. On the other hand, if the same proportion was used in the insurance company's tax base, the use of an approximation would not appear to create any gaps in the tax base, nor would the resulting treatment overtax these activities.

#### 4.3.4 The Committee's view

The Committee's view is that the preferred treatment of policies covering business-related risks is to make premiums non-deductible and claims non-assessable. This treatment would have the advantage of being consistent with the Committee's preferred treatment of policies covering private risks. It would therefore provide a uniform treatment of all policies and avoid the need for Inland Revenue to make judgements as to whether the exact nature of particular policies is term life, savings life or disability replacement income.

#### 4.4 Boundary Problems

The issue here is whether changes should be made to the treatment of life and disability premiums and claims without making similar changes for other types of insurance. Inconsistent treatments of different types of insurance could create incentives to rearrange insurance contracts to be more tax-effective.

Given that life and disability policies cover the loss of human capital, as opposed to other types of capital asset, it would be possible to identify such policies and apply a separate tax treatment. However, a potential problem arises in respect of loss of profits policies which may cover the risk of losses of human or non-human capital.

The premiums for loss of profits policies are currently deductible under section 104(a) and the income from such policies is taxable under section 65. If premiums for disability and life policies were made non-deductible in isolation, businesses would have an incentive to switch to loss of profits policies in order to be able to deduct the premiums.

#### 4.5 Transitional Problems

Switching to a Taxed/Taxed/Exempt regime for disability insurance policies which are currently subject to an Exempt/Taxed/Taxed regime would give rise to windfall losses for those insurance companies carrying such policies on their books. This is because the payments would become tax-free and it would therefore suddenly be relatively more attractive for policyholders to become disabled, and stay disabled for a longer period of time as there would be a financial disincentive to return to work. That is not to say that individuals would deliberately seek to become and to remain disabled. Rather, the Committee considers that there would be an increase in claims payments relating to disabilities that are difficult to verify (eg back problems).

Two factors mitigate these concerns. Firstly, insurance companies already have to deal with the moral hazard problems of insurance, ie they have mechanisms for investigating the validity of claims. Secondly, tax changes invariably impose windfall gains and losses on taxpayers. However, this is not generally used to argue against a proposed change. Rather it may be an argument for some transitional arrangements to assist in the adjustment process. The Committee notes that the recent change to the tax treatment of annuities was accompanied by legislation permitting life offices to adjust annuity contracts. A similar approach could be taken in the case of disability policies.

#### 4.6 Conclusion

The Committee considers that the best approach would be to make all life and disability premiums non-deductible and claims non-assessable. However, this treatment would not be consistent



with that currently applying to fire and general insurance. In particular, the treatment would not be consistent with the treatment of loss of profits insurance policies. Moving all life and disability policies to a Taxed/Taxed/Exempt regime could therefore create incentives for insurance contracts to be rearranged. Some existing contracts would also be disrupted. In the light of these problems, the Committee's view is that the present regime for life and disability premiums and claims should remain in place until the tax treatment of fire and general insurance is reviewed by the Government. In the meantime, the Committee considers that it would be useful to legislate the current treatment.

### **Recommendations**

The Committee recommends that:

- a the tax treatment of all life, disability, and fire and general insurance premiums and claims be reviewed and consideration given to making all such premiums non-deductible and claims non-assessable;
- b the current treatment of life and disability insurance premiums and claims be retained in the meantime; and
- c the current Inland Revenue interpretation of the tax law relating to life and disability premiums and claims be translated into legislation.

## **APPENDIX - PRESENT TAX TREATMENT OF LIFE AND DISABILITY PREMIUMS AND CLAIMS**

As noted in section 4.2.3 above, the present tax treatment of life and disability premiums and benefits is somewhat unclear. To remove the present uncertainty, the Committee proposes that the current tax law relating to life and disability premiums and claims be clarified, in general by translating into legislation current Inland Revenue Department policy. The Committee's understanding of that policy is set out below.

### **1 Life Insurance Purchased by an Employer - Benefits for Employees**

Premiums are deductible to employers as part of employee remuneration. Premiums are included as "expenditure on account" and assessable to an employee if the employee has an indefeasible right to benefits otherwise than on death, or if the policy has a cash surrender right. Otherwise, premiums are subject to FBT. Benefits paid under such policies are non-assessable.

### **2 Life Insurance On Lives of Employees Purchased by an Employer - Benefits for Employer**

The Inland Revenue Department's Public Information Bulletin 106 states that a deduction is allowed where the policy is a term policy on the life of an employee. Benefits are then assessable. If the policy is an endowment or whole-of-life policy on the life of a "key" employee taken out for the purpose of protection of profits, premiums are non-deductible and benefits are assessed to the extent to which they exceed premium payments.

### **3 Life Insurance Purchased by an Individual**

There are no deductions for premiums paid on such policies and benefits are not assessable.

### **4 Income Maintenance Policies Purchased by an Individual**

The Committee understands that a deduction is available for premiums (under sec 104) if benefits are assessable. Since most benefits under such policies are calculated on the basis of loss of profits or earnings they do not qualify for the income tax exemption under section 61(40). Accordingly, most benefits are assessable under section 65(2)(1) or (j). Therefore, in general, premiums are deductible and benefits are assessable.

### **5 Income Maintenance Policies Purchased by an Employer - Benefit to Employee**

Premiums on such policies are deductible to the employer as employee remuneration. Premiums are assessable to the employee if the employee can convert the policy to cash. Otherwise, the premiums should be subject to FBT. Benefits are assessable if

calculated according to loss of earnings or profits.

**6 Income Maintenance Policy Purchased by an Employer - Benefit to Employer**

The Inland Revenue Department's Public Information Bulletin 106 states that a deduction is allowed where the policy insures the continued availability of an employee. Benefits are then assessable. A deduction is not otherwise available.

## CHAPTER 5 - THE TAX TREATMENT OF FRIENDLY SOCIETIES

### 5.1 Introduction

Friendly societies are mutual associations set up to provide financial and other assistance to members and their families in times of need, principally sickness, old age and death. Their operations are based on insurance principles and mutual sharing of risk, with benefits being paid from funds accumulated from the contributions of members. However the traditional friendly society provides more than just financial assistance. The regular meetings of members are occasions for social as well as business activity. The strength of the fraternal organisation must be appreciated to have a complete understanding of the nature of the traditional friendly societies. While these fraternal activities are undoubtedly of benefit to members and others, it is the financial aspects of friendly societies upon which one must focus in determining an appropriate tax basis.

Friendly societies are currently exempted from income tax by Section 61(23) of the Income Tax Act. The removal of this special tax concession applying to friendly societies was first announced in the Government's Economic Statement of 17 December 1987. This announcement was followed by the release of Volume 2 of the Government's Consultative Document (CD) which set out options for taxing friendly societies in Chapter 6.

The discussion and recommendations in this chapter relate to the income tax treatment of all friendly societies including those involved in health insurance. Members of health insurance friendly societies have also benefited from a concessional treatment of premiums which is discussed in the next chapter. That chapter also canvasses the arguments for and against tax incentives for health insurance generally.

### 5.2 Options Proposed in the Consultative Document

The CD discussed the following three alternatives for taxing the insurance and investment activities of friendly societies.

#### a Option 1 - Tax as non-mutuals

This approach would apply the same regime to friendly societies as applies to fire and general insurers. The tax basis would be premiums received, plus investment income, less claims paid and less expenses.

The CD noted that this tax treatment has the drawback that there would be the incentive for friendly societies to set premium and interest rates on loans to members in a way that minimised taxable profit. Thus commercial decisions would tend to be distorted by the tax system. With the ability to minimise tax in this way, friendly societies would have a competitive advantage

over other non-mutual organisations.

For these reasons the CD recommended that if this option were adopted, it would be desirable to maintain at least some of the existing regulatory controls.

#### Comment

The difficulty with the "fire and general" income basis of option 1 is that in respect to long-term business such as funeral benefits, the net income in a given year, without allowance for accruing liabilities, is not a true measure of profit. Some of that income must be set aside for future claims. For small friendly societies the cost of actuarially adjusting income would be prohibitive.

We accept the comment in the CD that there is scope for a mutual organisation to reduce tax by providing benefits at lower than the market rate, thereby eroding the tax base. This is discussed further below.

#### b Option 2 - Market related income tax treatment

This option aimed to prevent a tax advantage arising from the opportunity to return profits to members in the form of reduced premiums for a given level of benefits, or by charging reduced rates of interest on loans to members. The CD suggested applying an objective benchmark market price for services offered, against which the effective discount being offered by the friendly society would be calculated. The discount would then be added to the assessable income of the friendly society. A similar concept already exists in section 22(3) of the Income Tax Act. There is also a provision in respect of concessionary loans to members of superannuation schemes (section 232A of the Act).

The CD noted that this option would result in a non-concessionary tax regime and thus allow for the relaxation of regulatory controls.

#### Comment

The CD discussed a difficulty with option 2 in that given the dominance of friendly societies in health insurance business, the information to assess the market price for those services offered by friendly societies is likely to be thin. Difficulties will also arise in establishing the objective benchmark prices, as prices charged by non-mutual companies will vary. With the exception of concessional loans to members (dealt with under paragraph 5.4.6) the Committee does not believe the application of a market related income tax treatment to be practical.

In practice we believe there is little other difference between the premiums charged by mutuals and non-mutuals. Although with the introduction of a tax regime there is the potential for

minimising tax by reducing premiums to members, any prudent insurer will continue to focus on the risk element rather than tax considerations.

c Option 3 - Taxation of net investment income

The final CD option is to tax friendly societies on investment income net of investment expenses. This approach is to treat friendly societies essentially as investment or savings vehicles. The approach capitalises on the incentive for friendly societies to maximise returns from the investment of funds.

The CD noted that this option would not achieve a non-concessionary tax regime unless the option 2 discount on interest charged to members was included in assessable income, or a certain proportion of funds was required to be invested with non-members.

Comment

Although this option is similar to the present tax base for life offices, in view of the new proposals for the taxation of life offices the Committee believes option 3 would unfairly penalise friendly societies by allowing a deduction for investment expenses only rather than full expenses. We also perceive a problem for societies in distinguishing general overheads between investment business and other business.

We consider that any requirement to invest funds with non-members would unreasonably interfere with the operations of friendly societies and would be ineffective unless all funds were invested at arms-length.

5.3 Submissions Received

The Committee received a total of 22 submissions relating to friendly societies:

New Zealand Council of Friendly Societies	1
medical care societies	2
traditional friendly societies	9
actuaries and consultants	2
UFS Dispensaries	1
other	7

We met with representatives from the New Zealand Council of Friendly Societies, Manchester Unity Friendly Society and Southern Cross. (Submissions relating particularly to concessions for health insurance are discussed in the next chapter.)

Some of the recommendations made in the submissions have been accepted by the Committee and are discussed in later paragraphs. Other matters raised deserve some comment at this stage.

Several of the submissions argued that the voluntary unpaid work carried out by many officers of friendly societies should be recognised and allowed as a deduction for tax purposes. They objected to the taxing of the results of voluntary efforts. However the Committee was not sympathetic to this argument. If that work was in fact paid, rather than voluntary, then tax would accrue on the payments in the hands of those officers. While it is admirable that officers donate the after-tax value of their efforts, it does not seem reasonable for the friendly society to expect a tax deduction for services obtained at no cost to the society.

Several submissions also requested continued tax exemption to recognise the social role of friendly societies in assisting members in need, but the Committee was not persuaded by the argument. Many other people and organisations fulfil a similar role without special tax or other assistance.

The mutuality principle was also discussed in a number of submissions. It was argued that friendly societies are groups of individuals effectively trading with themselves, that it is impossible to make a profit with oneself, and that they should therefore not be liable to tax. This argument was not accepted by the Committee. Friendly societies are little different from mutual life assurance companies in this respect. This aspect is discussed further in Chapter 7 on credit unions.

Two submissions sought tax at 50 percent of the "normal" rate if the present restrictive controls embodied in the Friendly Societies and Credit Unions Act are not relaxed. We understand that the Act is currently being reviewed to place friendly societies (and credit unions) as much as possible in a neutral competitive position with other organisations with minimal restrictions and advantages.

#### 5.4 Proposed Basis of Taxation for Friendly Societies

The business of friendly societies has counterparts in other organisational forms. For example, health insurance is written by industrial and provident societies and insurance companies as well as friendly societies. Again life insurance and annuities are provided by both life insurance companies and friendly societies. It is therefore important that the tax regime for any particular business activity is the same or essentially similar regardless of the organisational form under which the business is operated. Otherwise not only might tax revenue be lost but business will be distorted towards that organisational form with the lowest tax burden. Essentially therefore the aim is to tax friendly societies on the component parts of their business as for other businesses in those areas. For example the health insurance business of a friendly society should be taxed as for any other health insurer and the life assurance business of a friendly society should be taxed as for a life office.

There is another aim for an appropriate tax basis for friendly societies and this, to a certain extent, acts contrary to the first aim. Friendly societies are frequently administered by voluntary and non-professional people, particularly in the smaller societies. This argues for simplicity in the definition of the tax base. Also the level of business operations in many societies is so low that a reasonable basis for say a life office might involve compliance costs which would cripple a small friendly society. If the tax basis is modified to meet the requirements of simplicity and minimum compliance cost, there will need to be limits on the application of the modified basis.

#### 5.4.1 Medical business

The medical business of friendly societies should be taxed on the same basis as proposed for other health insurers i.e. as for a fire and general insurer. The concept is that the business is short-term in nature and the profits of such medical business are essentially total premiums received, plus investment income (including net realised investment gains), less claims paid and all investment and management expenses. Management expenses will include the costs of acquiring new business.

#### 5.4.2 Other insurance business

Other insurance business conducted by friendly societies tends to be either of a savings nature or of a long-term insurance nature, requiring the establishment of reserves to meet future claims. In this sense they are similar to the operation of a life office. Accordingly the tax rules for life offices should apply to this business (refer to Chapter 2 of this report). However we accept that the complexities of such a tax regime, if applied to all the non-medical insurance business of friendly societies, would involve excessive compliance costs, particularly as the potential tax revenue is not great. The level of many friendly society operations is low and the cost of annual actuarial valuation of all funds would be prohibitive.

The Committee feels that the business insured through the life assurance funds of friendly societies should be capable of annual valuation without excessive cost. This is already carried out by some of the major societies and contemplated by others and would be desirable from the point of view of timely bonus declaration, rather than the five-yearly valuations of the past. The Committee therefore recommends that those life assurance funds pay tax as for a life insurance company.

Societies commonly operate funds insuring sickness, annuity and funeral benefits. The funeral funds usually provide benefits at very low levels, essentially to cover, or pay part of, the costs of a funeral. They are usually based on standard tables of contributions and benefits and differ from the flexibility offered through the life assurance funds. Provided these other



death/funeral benefits (i.e. other than benefits insured through the life assurance funds) do not exceed \$5,000 (including bonuses) and sickness and annuity benefits do not exceed \$600 (including bonuses) per annum, in respect of any member, we consider that an option should be available for friendly societies to return income for tax purposes on a simplified basis for those funds viz. investment income (including net realised investment gains) less all investment and management expenses.

Any amounts above these limits would need to be insured through the life assurance fund. Otherwise the whole of the insurance business of the society would be liable to tax as for life insurance companies.

The limits are designed to avoid the scope for other insurers to reduce their tax liabilities by setting up as a friendly society. For this reason it would also be necessary to require that any annuity business written after 31 March 1990 is insured through the life assurance fund.

Friendly societies frequently operate a number of other funds (e.g. benevolent funds, surplus funds covering distributions of past surplus allocated to individual member's accounts). These other insurance/savings funds could reasonably fall within the above simplified tax option.

The Committee accordingly recommends that the above simplified tax basis may be used for all the insurance and savings-type activities of friendly societies, other than medical and life assurance, provided they do not exceed the above limits.

The option for the simplified tax basis of investment income less all expenses does provide a concession by allowing all management expenses as a tax deduction, as the expenses will include costs relating to insurance underwriting business, rather than only investment expenses. In view of the advantages arising from ease of compliance, the restrictions of societies adopting the simplified option, and the small loss of tax revenue, the Committee believes that the concession is justified.

#### 5.4.3 Other business

If the current review of the Friendly Societies and Credit Unions Act empowers friendly societies to undertake business other than medical, sickness, funeral and life assurance then such other business should be taxed as for business of that type carried out by other organisations.

#### 5.4.4 Deductible expenditure

As mentioned earlier, an important part of the activities of many friendly societies revolves around the fraternal or social aspects. The costs associated with these social activities should be met from taxed income.

We therefore recommend that allowable expenses for tax purposes should include only those expenses incurred in gaining investment income and in acquiring and administering the financial business of friendly societies. The costs relating to social activities should be disallowed.

Despite the submissions which refer to extensive voluntary work by officers, the administration expenses of friendly societies appear to be very high. In 1987, administration expenses of the traditional friendly societies totalled over \$7 million (including expenses relating to fraternal activities) and compared with total financial benefits of \$5.8 million (sickness, death and annuity benefits) provided by those societies.

#### 5.4.5 Capital gains

The Committee considers that friendly societies can be regarded as similar in nature to the banking and general insurance industries, which are taxed on net realised capital gains in accordance with general law (rather than by a specific tax on capital gains). Given the investment activities of friendly societies, this approach will mean that in most instances tax will be payable on realised capital gains.

#### 5.4.6 Low interest loans to members

In the Committee's view, the relationship between a friendly society and its members is similar to that between a company and its shareholders. The Government has proposed that a company providing low interest loans to shareholders should be subject to FBT on the extent to which the interest rate on loans to shareholders is less than the prescribed rate for FBT purposes. This recognises the fact that such loans are an alternative means of distributing corporate income to shareholders. We can see no justification for a general exemption from this rule with respect to friendly societies.

Where members receive loans on non-commercial terms relating to interest ("non-commercial" terms of interest being less than the rate as determined for fringe benefit tax purposes), the Committee recommends that the discount on interest actually charged to members should be subject to FBT. This treatment will not preclude friendly societies from charging low rates of interest on loans to members, but it will prevent a tax advantage from doing so. The calculation of the interest discount shall be determined, not on an individual loan by loan basis, but rather by determining the average yield on all non-commercial loans to members. This calculation will be done on a quarterly basis as follows.

A loan will be included as "non-commercial" in a quarter if the interest charged over the quarter is less than the FBT rate applied to the amount of the loan. Interest at the prescribed

quarterly rate for FBT purposes will be calculated on the average of each quarter's opening and closing total non-commercial loans to members. The total interest charged during the quarter in respect of those loans will then be subtracted. FBT, currently at the rate of 49%, will be charged quarterly on the discount so determined.

The Committee recognises that the above recommendation might significantly change the way in which some small friendly societies have operated, without the prospect of substantial tax revenue, and accordingly recommends that the smaller friendly societies be exempt from the requirement to pay FBT on low interest loans to members. The Committee proposes that a friendly society be exempt from this requirement in each quarter where:

- the organisation existed and had assets under \$1m as at 1/4/89; and
- the organisation has assets under \$1m at all times during the quarter.

Our proposal would exempt the small friendly societies presently in existence. Currently, only about 15 friendly societies have assets over \$1m. All new friendly societies would have to pay FBT on interest discounts irrespective of the organisation's size.

#### 5.4.7 Tax rate

In general, submissions argued that a concessional rate of tax should apply to friendly societies. It was contended that a lower tax rate is justified in order to equate the tax rate for friendly societies with the lower tax rates applying to the incomes of most members. Many submissions also pointed to the income that arose through the voluntary work of members in the organisation of friendly societies. Several suggested the tax rate for friendly societies should be 50% of the company rate. Some comment on these matters has already been made in paragraph 5.3.

The Committee did not accept the arguments for a concessional rate of tax. We concluded that the friendly society tax rate needs to be set having regard to the marginal tax rates of friendly society members and that a 33% tax rate is appropriate under the current tax structure. When considering the personal tax rate structure regard has to be had to effective tax rates, not just the nominal tax rates set out in the First Schedule of the Income Tax Act. Effective tax rates include the national superannuitant surcharge and the abatement of various income support measures, such as the low income rebate and family support. The Committee is also of the opinion that the tax rate for friendly societies should be the same as that for life insurance policy holders. To apply a lower tax rate for friendly societies might encourage other organisations to set up as

friendly societies in order to reduce their tax liabilities.

#### 5.4.8 Implementation date

The Consultative Document proposed that friendly societies be subject to tax as from 1st April, 1989. The Minister of Finance has since announced that the new tax regime for friendly societies will not apply before the income year commencing 1st April, 1990. The Committee considers that the application of the new tax provisions from the income year commencing 1st April, 1990 is appropriate to enable friendly societies to establish the necessary accounting procedures. This means that for any balance dates falling between 1 October 1990 and 30 September 1991 tax would be payable on business conducted over the full year ending on that date.

Valuations of assets will be required as at the commencement of that first tax year for determining capital gains.

#### **Recommendations**

The Committee recommends that:

- a the medical business of friendly societies be taxed as for other health insurers, ie as for a fire and general insurer. The tax base would then be premiums received plus investment income less claims paid less all investment and management expenses;
- b the life insurance funds of friendly societies be taxed as for life insurance companies (refer to Chapter 2);
- c all the funeral, sickness and annuity insurance business of friendly societies be allowed a simplified tax base of investment income less all investment and management expenses, provided that business does not exceed specified limits. Otherwise the life insurance company basis would apply;
- d general tax law (rather than a specific tax) apply to realised capital gains;
- e any interest discount on loans to members, as measured by reference to the prescribed FBT interest rate, be subject to FBT, except where the friendly society:
  - existed and had assets under \$1m as at 1/4/89; and
  - has assets under \$1m at all times during the quarter;
- f the tax rate applying to the income of friendly societies should reflect the effective marginal tax rate of members, at present 33%; and
- g taxation of the income of all friendly societies apply from the income year commencing 1 April 1990.

## 5.5 Tax Treatment of Other Structures

### 5.5.1 Sickness, accident and death benefit trust funds

The above funds are at present exempted from income tax by Section 61(41) of the Income Tax Act. The Consultative Document proposed that as a transitional measure those funds be taxed on a net investment income basis, including net income from realised investments, as from 1 April 1988 at the rate of 25%. Further, the Consultative Document suggested transitional measures for the payment of provisional tax. The Consultative Document noted that the treatment of such funds from the 1989/90 tax year would be reviewed when the tax regime for friendly societies was determined.

No legislation with regard to these changes has yet been passed.

### **Recommendations**

The Committee recommends that:

- a the tax base for sickness, accident and death benefit trust funds be premiums received plus investment income (including net realised capital gains) less claims paid less all investment and management expenses;
- b the tax applies from the income year commencing 1st April 1990;
- c the tax rate should reflect the effective marginal tax rate of members, at present 33%; and
- d no concessions apply for provisional tax payments.

### 5.5.2 Other societies registered under Part II of the Friendly Societies and Credit Unions Act

Section 11(1) of the Friendly Societies and Credit Unions Act makes provisions for differing types of societies. Section 11(1)(a) provides for the friendly societies upon which the discussion in paragraph 3 has been based.

Section 11(1)(b) allows registration of benevolent societies which provide benefits similar to friendly societies but with a lesser degree of security. Long term costing of the affordability of benefits is not carried out but nevertheless significant reserves are usually built up for future claims. In practice their operations are more in the nature of fire and general insurance. Benevolent societies are therefore essentially very similar to sickness, accident and death benefit trust funds and the same tax treatment should apply.

Section 11(1)(d) provides for specially authorised societies.

The only two societies registered under the subsection provide fidelity insurance for officers of friendly societies. As these activities are in the nature of fire and general insurance the Committee considers that the tax basis should again follow that for sickness, accident and death benefit trust funds.

#### 5.5.3 Trade unions and working mens clubs

Our terms of reference did not appear to include these organisations. The Committee sees no reason why they should not be taxed on their income. By virtue of the definition of friendly society in the Income Tax Act, these organisations are exempted from income tax for business carried on within their membership circle by Section 61(23) of the Act. A total repeal of Section 61(23) would bring the income of these organisations to tax. The Committee also noted that trade associations and employer organisations are already taxed.

On the other hand, the Committee is aware that few trade unions expected that their tax position would be considered as part of the present review. Accordingly, only a few submissions were received from these groups.

#### 5.5.4 United Friendly Society (UFS) dispensaries

UFS Dispensaries are pharmacies owned by groups of friendly societies whose members received discounted goods and services. As the Consultative Document notes, their registration as friendly societies has been found to be inappropriate (and illegal under the FSCU Act) and an amendment to the Pharmacy Act is being prepared to enable UFS Dispensaries to register under that Act. They would then automatically be subject to company tax on all their business. At present they pay tax only on a portion of their business, broadly being the proportion of business conducted with non-members.

## CHAPTER 6 - THE TAX TREATMENT OF HEALTH INSURANCE PREMIUMS AND CLAIMS

### 6.1 Introduction

The Consultative Document (CD) noted that while some general insurance companies and industrial and provident societies offer health insurance, this type of cover is primarily provided by friendly societies. The largest insurer is the Southern Cross Medical Care Society, which has a current membership of over 1 million.

Other organisations offering medical insurance include New Zealand Medicare Society, Aetna Health Corporation Limited, Medic Aid Fund Society, Health Care Fund of the Druids Friendly Society, and Union Medical Benefits Society Limited.

Total expenditure on health insurance in 1987 would have been approximately \$100 million.

The CD noted that in New Zealand health insurance involves the partial or full cover of private hospital and practitioner expenses in return for an annual premium. Benefits may also be provided in the form of income support payments, funeral benefits or through the waiving of premiums. In addition to the major insurers, many other friendly societies provide health insurance on a smaller scale.

The tax treatment of friendly societies was considered in Chapter 5 above. The recommendations made in that chapter apply to all friendly societies, including those involved in health insurance. This chapter focuses on the tax treatment of health insurance contributions/premiums paid to friendly societies and other health insurers and the benefits received from these organisations. It also canvasses the arguments made in the CD and submissions concerning tax concessions for health insurance.

### 6.2 The Previous Treatment

#### 6.2.1 Premiums/contributions paid by the individual

The exemption for an individual taxpayer for health insurance premiums was tied into the exemption for life insurance premiums and superannuation contributions. Under section 59 of the Income Tax Act taxpayers were able to claim an exemption for premiums or contributions to funds providing benefits in the event of sickness, accident or death up to a maximum of \$1,200 per year where the taxpayer was also a member of a subsidised superannuation scheme and \$1,400 per year for other taxpayers. Payments that have been claimable under the exemption include:

- premiums on personal accident or sickness insurance;

- payments to any insurance fund of a friendly society of which the taxpayer was a member on or before 8 November 1984;
- payments to any insurance fund of a friendly society providing benefits solely in respect of accident, disease, sickness or expenses consequent on death;
- payments to any fund providing benefits solely in respect of accident, disease, sickness or expenses consequent on death where the fund was approved by the Commissioner of Inland Revenue.

Premiums on policies providing replacement income have also been deductible under section 104 since the proceeds of such policies have been assessable.

#### 6.2.2 Premiums/contributions paid by the employer

Premiums or contributions paid by employers for health insurance in respect of employees have generally been deductible under normal tax principles, being a business related expense.

An exemption from Fringe Benefit Tax was provided under section 336N where an employer paid premiums or made contributions on behalf of employees to funds providing benefits in the event of sickness, accident or death. Qualifying payments were:

- premiums on personal accident or sickness insurance;
- payment to any insurance fund of a friendly society of which the taxpayer was a member;
- payments to any fund providing benefits solely in respect of accident, disease, sickness or expenses consequent on death where the fund was approved by the Commissioner of Inland Revenue.

#### 6.2.3 Benefits

Section 61(39) of the Income Tax Act exempts income derived, in respect of any incapacity for work, from a friendly society or from a sickness, accident or death benefit fund to which the person was a contributor at the start of the period of incapacity.

Similar benefits paid under a policy of sickness or accident insurance are exempt by virtue of section 61(40) unless the payments are calculated according to loss of profits or earnings in which case they are taxed.

### 6.3 The Arguments For and Against Tax Concessions - The CD

The CD set out arguments against the need for tax concessions in the area of health insurance. These arguments are restated in brief below.



### 6.3.1 The distribution of benefits from the concessions

The CD referred to a survey by the Health Benefits Review Committee that demonstrated that between 1.1 and 1.3 million New Zealanders held private medical insurance in 1986. The CD commented that approximately 35 percent of the population aged 15 or over held full private medical insurance. Coverage was found to vary markedly depending on factors such as age and income. Coverage was found to be most common amongst the 36 to 50 age group - 47 percent of this group held medical insurance. Despite the fact that the elderly are proportionately the heaviest users of health services, the survey found that only 13 percent of those in the 65+ age group were insured.

Coverage for those employed in the paid labour force was estimated at 42 percent compared with 24 percent for the rest of the adult population. The survey results also showed that coverage was below average amongst individuals experiencing recent or chronic ill health.

The distribution of private medical insurance by household income was also uneven. The survey found that coverage amongst those in the higher household income brackets was 47 percent, while only 27 percent of those in the lower household income brackets held private medical insurance. The CD noted that the associated distribution of tax concessions for health insurance was more heavily weighted toward higher income households than these statistics suggest because tax concessions given in the form of exemptions of income (or deductions from assessable income) are of greater value to those on higher marginal tax rates.

The CD concluded that the major beneficiaries of the tax concessions have been those who are less likely to need care and those less likely to experience financial difficulty in obtaining access to care.

### 6.3.2 Effect on the demand for public health services

The CD considered whether subsidised health insurance led to a reduction in the demand for public health services. It concluded that in the short term greater use of private health services is not likely to reduce pressures on public services.

Another argument discussed in the CD was that the private health sector should be encouraged because it is considered more efficient than the public sector. The CD concluded that if the private sector is indeed more efficient, that in itself does not imply that tax concessions for public health insurance are necessary. It was suggested that a more appropriate response would be for Government to purchase services from the private sector directly - for example by contracting for the provision of services for the public.

### 6.3.3 Effect on the allocation of resources

The CD referred to the inefficiency of the current system whereby the costs of health services are borne by three different funders, namely individuals, insurance companies, and government. It noted that where funding is shared in that way between three parties, there is little incentive for any one of the parties to control the expenditure on the services being supplied. The CD commented that insured individuals may use services beyond the point where the cost equals the benefit at the margin, and the level of resources used in the private health sector may be excessive.

### 6.4 Submissions Received

The Committee received a total of 11 submissions from:

Health insurers	6
Others	5

We met the following:

Southern Cross  
 Manchester Unity  
 New Zealand Council of Friendly Societies

The main comments made in submissions are outlined below.

#### 6.4.1 The distribution of benefits from the concessions

Two of the submissions disputed the validity of the statistical information referred to in the CD. They claimed that more recent information showed that many more New Zealanders had private health insurance than stated in the CD. One of the submissions referred to the findings of a survey carried out for the Royal Commission on Social Policy. That survey found that 25 percent of Maori people have insurance, 23 percent of those aged 60 or older are insured and that 38 percent of those with labouring jobs are covered. On the basis of the statistical information they presented, the submissions disputed the conclusion reached in the CD that the major beneficiaries of tax concessions are those who are less likely to need medical insurance and those who are best able to pay for it themselves.

It was argued that if health insurance is enabling a larger percentage of the population to have access to better quality health care then individuals should not be discouraged from taking out insurance. It was suggested that the removal of tax exemptions and the imposition of Fringe Benefit Tax on employer contributions would discourage private insurance cover.

Southern Cross informed the Committee that the introduction of FBT on employer contribution/premiums had caused a number of schemes in which employers provided health insurance for their employees through Southern Cross to be wound up. They noted that the number

of such scheme terminations was increasing.

#### 6.4.2 Effect on the demand for public health services

Two of the submissions disagreed with the conclusion in the CD that health insurance does not reduce public expenditure on health care significantly. Both were of the view that the health care industry provided services needed but not available in the public system. They submitted that the private health care industry reduces demand on the public sector and therefore reduces public expenditure.

It was submitted that there is insufficient government funding available to meet the demands on the public system and accordingly, the government should provide incentives to bring additional resources to the health care sector.

One of the submissions disagreed with the argument raised in the CD that some services covered by private insurance may not be available in the public sector. To support their argument they carried out an examination of all operations carried out in private hospitals in New Zealand in 1985. Those operations were compared with all operations carried out in public hospitals during that year. They concluded that out of 550 different surgical procedures performed in private hospitals in New Zealand in that year, only 4 of those were not performed in public hospitals. They argued that the only reason that those 4 procedures were not carried out in public hospitals in that year was because of their rarity as opposed to being operations which would not normally be carried out in public hospitals.

One of the submissions argued that other than in the case of physiotherapy there was no evidence to support the argument that increases in demand for private care mean that resources, especially health care personnel, are attracted away from the public sector. It was noted that in the case of physiotherapy the diversion was caused entirely by ACC funding.

One of the submissions referred to the findings of the Gibbs report. In particular it referred to the findings in that report that the majority of medical specialists worked in both the public and private sectors and that the productivity of medical specialists was higher in the private sector. It was argued that competition from the private sector should be seen as a good thing, which should lead to improvements in the public sector. In addition, it was argued that if all the private sector work load was diverted to the public sector (where on the basis of information put forward in the submissions it was found that the length of the patient's stay is longer) it would result in an additional cost of over \$230 million per annum to the public sector. This estimate did not include additional capital expenditure and other resource diversion.

One agreed with the conclusion reached in the CD that private

sector efficiency may best be recognised by the government encouraging the purchase of services from the private sector. However, it was submitted that it would be some time before this could be achieved, and that until then, the tax regime should not be changed.

Another submitted that the government should recognise the efficiencies of the private sector by encouraging the development of medical insurance from the private sector (the implication being that this encouragement should be by way of tax concessions).

#### 6.4.3 Effect on the allocation of resources

Three of the submissions argued that private health insurance does not lead to abuse of health insurance facilities by consumers. It was stated that there was evidence (including overseas experience) to show that abuse can be avoided by a number of devices. They argued that they had in place management systems and controls to avoid abuse. It was submitted that health insurers in fact control costs, which benefits all parties.

It was argued that the CD contained assumptions which under-estimated the sophistication of the health insurance industry. It was submitted that health insurers in New Zealand had learnt from overseas experience and that they were not aware of the supposed over use of services by people with health insurance. In support of this argument one submission referred to the Royal Commission on Social Policy's survey on Health Insurance. It was noted that the survey found that 73 percent of insured persons had used health services in the past 12 months, compared with 70 percent of those without insurance. It was submitted that this difference was not significant.

#### 6.5 The Committee's View

The Committee agreed with the CD that the issue was not whether the provision and use of health insurance was desirable in New Zealand, but rather whether such health insurance should be subsidised by way of tax concessions. The Committee was not persuaded that a case had been made in submissions for the continued subsidisation of health insurance through the tax system.

With respect to the former personal tax exemption for health insurance, the Committee noted that the exemption was often fully utilised by superannuation and life insurance contributions. However, this did not appear to have hindered the growth of health insurance. This suggests that removal of the personal deduction should not have a marked impact on the purchase of private health insurance. Accordingly, the Committee considers that the removal of this concession has probably had only minimal effect.

However, the Committee also noted that the tax concessions for

employer-paid premiums and for the income earned by the institutions themselves, will have tended to encourage private health insurance. The Committee is therefore inclined to agree with the suggestion, made in many submissions, that the demand for private health insurance is likely to decrease as a result of the removal of these concessions. We also agree that this may lead to some increase in demand for public health services. However, none of the submissions put forward evidence to suggest that meeting that increased demand would cost more than is currently foregone in providing tax concessions.

The issue that has to be addressed is whether tax concessions for private health insurance are an efficient and equitable means of funding health services. The Committee was not persuaded of this by submissions and so supported the Government's decision to remove such concessions. In reaching this conclusion the Committee is mindful that health insurance has an increasingly important role to play in the funding of health services in New Zealand. As the rationalisation of the public health sector continues, the Committee considers that health insurance will no doubt become more important and widespread.

## 6.6 Changes Already Made

### 6.6.1 Premiums/contributions paid by individuals

The Committee discussed the appropriate treatment of insurance premiums and claims in Chapter 4 above. In that chapter we concluded that, in general, premiums for policies of disability and life insurance should be non-deductible and claims should be tax-free. This conclusion also carries over to other sickness and accident insurance. The Committee therefore accepts the recommendation in the Consultative Document that health insurance premiums and contributions should not qualify for a personal tax deduction. However, pending a review of the treatment of fire and general insurance premiums and claims, the Committee recommends that the current treatment of disability policies providing replacement income should continue.

The Section 59 exemption permitting premium deductions for pre 9 November 1984 policies of personal accident or sickness insurance, was abolished by s.4(3) Income Tax Amendment (No.2) Act 1988, with effect for premiums paid on or after 17 December 1987. This change did not affect the deductibility of premiums for income-replacement policies.

### 6.6.2 Premiums/contributions paid by employers

On normal tax principles, employers should be entitled to a deduction for expenditure on health insurance for employees where that expenditure is a business-related. However, since the insurance is a benefit to the employee, fringe benefit tax at the standard rate should apply.

The Fringe Benefit Tax exemption was removed from section 336M of the Income Tax Act in the Income Tax Amendment No 2 Act 1988 in respect of employer-paid premiums/contributions made after 17 December 1987. Different transitional FBT rates applied depending on the type of health insurance product.

- a The concessional FBT rate for payments to approved sickness, accident and death benefit funds existing on 17 December 1987 was 24 percent (non-deductible). The CD noted that the concessional rate was adopted as a transitional measure in recognition of the fact that income earned by such funds was previously exempt;
- b All other payments previously exempt were subject to FBT at the rate of 35 percent as from 17 December 1987.

As an additional transitional measure, FBT on premiums/contributions paid between 17 December 1987 and 31 March 1988 were not due until 20 July 1988. From 1 April 1989 the FBT cost has become deductible and the standard rate has increased to 49%.

#### 6.6.3 Benefits

The CD recommended that all proceeds of policies of sickness or accident insurance and benefits paid from sickness, accident and death benefit funds be tax free from 1 April 1989. As discussed in section 6.6.1 above, the Committee agrees that the proceeds of health insurance policies should be tax free. However, pending a review of fire and general insurance, the Committee recommends that the proceeds of policies providing for replacement income should continue to be taxed. Other health insurance benefits should continue to be tax free.

#### **Recommendations**

The Committee:

- a recommends that health insurance, with the exception of premiums for income replacement policies that are currently deductible, should be paid for by individuals out of their after-tax income;
- b endorses the removal of the previous FBT exemption for employer-paid health insurance premiums; and
- c recommends that the benefits from health insurance policies, with the exception of currently taxable benefits designed to replace income, should be tax free to the insured.

## CHAPTER 7 - THE TAX TREATMENT OF CREDIT UNIONS

### 7.1 Introduction

Credit unions are co-operative savings institutions which are registered under the Friendly Societies and Credit Unions Act 1982. The role and function of a credit union was, in our view, best summarised in one of the submissions to the Committee made by the New Zealand Credit Union League. That submission stated:

"A credit union is a ... non-profit financial co-operative having the objectives of the promotion of thrift among its members by accumulating their savings for the mutual benefit of the members. Wider social aims are the training and education of members in the wise use of money. The principal activity of the credit union is the making of low cost loans to members from the common pool of savings contributed by all members."

A credit union is therefore in part a financial institution. As with any bank or similar organisation, it borrows money by taking in deposits (in the credit union's case these are in the form of "shares" which pay interest in the form of "dividends"). The pool of funds thus accumulated is then lent out to borrowers. There are, however, a number of factors which together distinguish credit unions from other financial entities. It was submitted to us that these distinguishing characteristics are as follows:

- a A credit union is neither a trust (although the assets of a credit union are held by trustees) nor incorporated under company law. It is instead established under the Friendly Societies and Credit Unions Act by way of registration under that Act.
- b The Act imposes a number of constraints on credit unions including:
  - requirements that members have a common bond which is usually residence within a particular locality, a common employment relationship, or common membership of a friendly society;
  - restrictions on investments largely to lending money to members;
  - limited power to borrow money other than from members; and
  - limits on investments by members (\$20,000) and lending to members.
- c Credit unions are co-operative ventures of members investing and dealing mainly within its circle of membership.

- d Credit unions also assume a social role of promoting good money management among their members.
- e Credit union membership tends to be focussed more than other entities among lower income earners and the less financially sophisticated. In particular, it was claimed in submissions that they are often the only source of lending funds available at "reasonable rates" to those with a poor credit risk.
- f Credit unions are generally small in size and rely heavily on voluntary efforts for their administration.

For the above reasons credit unions constitute a miniscule proportion of the overall financial sector (estimated at about 0.2%). The asset base of the average credit union is only about \$500,000 with only five credit unions having assets of over \$5 million in 1987. In general, loans to members advanced by credit unions are also small - the average being somewhat less than \$2,000.

As far as members themselves are concerned, normal taxation rules apply to their credit union savings. Deposits (share purchases) are made out of after-tax income, and interest received (dividends) are taxable in the hands of credit union members. The only special rule is that the credit union itself is exempt from taxation under section 61(23) of the Income Tax Act 1976. That section exempts the income of friendly societies from taxation except so far as it is derived from business carried on beyond the circle of its membership. A credit union is defined by section 2 of the Income Tax Act to be a friendly society for the purposes of that Act.

The effect of these rules is that the income derived by credit unions in the form of interest charged on member borrowings and income derived from any other allowable investment is not subject to tax unless and until it is distributed to members in the form of interest or dividends. It is then taxed as income of the recipient member subject to the limited section 61(13) exemption for interest and dividends which the government has separately proposed to phase out.

## 7.2 Options Proposed in the Consultative Document

Volume 2 of the Consultative Document on Superannuation and Life Insurance considered the taxation treatment of credit unions in Chapter 6. In line with the government's Economic Statement of 17 December 1987, it was proposed that the section 61(23) exemption be removed, with effect from the beginning of the 1990 income year, so far as it applies to credit unions. A relaxation and review of the regulatory regime applying to credit unions under the Friendly Societies and Credit Unions Act is also being carried out.



The Consultative Document then put forward three options for a replacement taxation regime for credit unions:

- a Tax credit unions under normal income tax rules with dividend payments to members being accounted for as interest payments which would be deductible to credit unions and assessable to members. This was seen as having the disadvantage of allowing credit unions to reduce their assessable income by effectively distributing it as low interest loans to members. Continued regulatory controls were therefore seen as being necessary if this option were adopted.
- b The second option was the same as the first but involved including in the assessable income of either members or the credit union the extent to which credit union income was effectively distributed as below market interest rate loans. This was seen as having the advantage of allowing for looser regulatory controls of credit union operations (while still retaining certain controls concerned with security of members' savings). On the other hand it was noted that it involved the determination of what was a low interest rate loan.
- c The third option advanced was to retain the existing tax rules for credit unions but to remove any exemption credit unions enjoyed with respect to investment income derived from non-members. This option would continue to provide credit unions with a tax advantage in certain circumstances but would involve double taxation in other circumstances. It was therefore not favoured by the Committee.

The Consultative Document stated that the government wished to implement a non-concessionary taxation regime for credit unions with a relaxation of regulatory controls. However, the exact nature of any future taxation regime was left open for consideration of the recommendations of this committee.

### 7.3 Submissions Received

We received a total of 47 submissions concerning the future taxation treatment of credit unions. Two of those submissions were detailed submissions by the New Zealand Credit Union League representing the majority of credit unions operating in this country. We met with and heard oral submissions from the League.

The majority of submissions tended to support the continuation of the existing taxation exemption for credit unions. The reasons advanced for retaining the exemption can be summarised as follows:

- a Credit unions carry out a useful social function in providing relatively cheap finance to, and in educating,

less financially sophisticated members of the community.

- b To a large extent the investment income of credit unions is derived from within its circle of membership. People should not be taxed on dealings with themselves - "the mutuality principle".
- c The amount of taxation revenue which could be expected to be derived from removal of the exemption is negligible. Most credit unions distribute nearly all their income by way of assessable dividend payments to members, frequently retaining only what is necessary to accumulate sufficient funds to meet statutory reserve requirements of between 5% and 10% of total assets.
- d Given the small scale operation of most credit unions and their heavy reliance on voluntary labour for administration of their affairs, the compliance costs involved in preparing taxation returns were argued to be crippling.

If the existing taxation exemption were to be removed the preference was for a regime which minimised compliance costs. In those circumstances, incorporation of credit unions into the taxation regime for co-operatives provided for in section 199 of the Income Tax Act seemed to be the most acceptable approach. In general that would allow credit unions to pay distributions (which would otherwise be treated as interest or dividends) as deductible rebates which would, as now, be assessable in the hands of members. There was considerable resistance to having to operate under the complexities of an imputation scheme.

Under such a regime the following issues were considered to be of importance:

- a A deduction should be allowed for the statutory reserves which credit unions are required to maintain on the grounds that such reserves are compulsory.
- b A deduction should also be allowed for the imputed costs of voluntary labour provided to the union.
- c Any change in the taxation regime should be implemented after, or at least in tandem with, regulatory reform.
- d A long transition period, of up to ten years, should be provided for before credit unions become fully taxable.

The issue of most concern, however, was the possibility that loans to members below a market interest rate could be included in the taxable income of either the credit union or union members. This was seen as being a punitive attempt to require credit unions to maximise income to the detriment of social goals such as the provision of low-cost finance to members. It was

argued that one of the main purposes of the existence of credit unions has been to provide such a facility. Any attempt to impose tax when that purpose was carried out was seen as an attempt to destroy credit unions.

We agree that credit unions operate on a different level and fulfill different functions to many other financial entities. However, that is not in our view sufficient to justify a taxation concession. Credit unions may have useful social objectives which banks, for example, may not always have. However, other organisations have similar objectives or objectives which are arguably of equal social worth. Those organisations do not benefit from taxation concessions unless they qualify, for example, under the exemption for charitable organisations. We see no reason why credit unions should be singled out for favourable treatment.

The Committee has concluded that continuation of taxation concessions for credit unions would be contrary to the government's overall taxation reform programme of removing tax-induced distortions from savings and investment decisions. We did not find any of the arguments advanced for continuing with the existing concession to be convincing enough to justify an exception to that general principle being made.

The "mutuality principle" is not one which the government has previously considered as warranting a taxation exemption. In that regard we agree with the comments in the Consultative Document that people can derive income by trading with an organisation which they own. Entities derive assessable income by providing people with goods and services. The taxation system should not deliberately discriminate between entities according to whether the owners of the entities also happen to be the consumers of its goods and services. It is for that reason that mutual and proprietary life companies should be taxed under the same general principles. Departure from this principle would be likely to encourage one organisational form over another with adverse economic effects.

Possible high compliance costs being imposed in order to raise a relatively small amount of revenue is a matter of legitimate policy concern. However, we were not convinced by the argument that the additional costs imposed by removal of the existing concession would be crippling. Indeed credit unions should be in a better position than many other small scale operations to comply with basic income tax requirements since, as financial entities, they should keep a reasonable set of accounts.

Finally, even if the additional taxation revenue to be gained from removing this concession were minor, it needs to be appreciated that a credit union is in theory at least a possible substitute for a superannuation scheme. Retention of the credit union taxation concession would be inconsistent with the government's moves to remove the concessions applying to

superannuation.

#### 7.4 Proposed Basis of Taxation for Credit Unions

We consider that the taxation regime for credit unions should be non-concessional and mirror as closely as possible the taxation regime applying to other similar entities. We were nevertheless impressed with the importance of minimising the compliance costs which credit unions will have to bear. With those concerns in mind we have looked at integrating credit union taxation into existing taxation regimes applying to various entities.

##### 7.4.1 Options considered by the Committee

One option would be to tax credit unions along the same lines as superannuation funds. That would mean that the total tax impost on savings income would be borne by the credit union. It would pay tax on behalf of its members with respect to their savings. All benefits (including interest or dividend income credited to or received by members) would be tax-free. However, this regime is not in our view appropriate for credit unions. It is appropriate for superannuation because of the nature of member interests which makes attribution of income to individual members on an annual basis difficult. Those considerations do not apply to credit unions.

A second option would be to tax credit unions under the imputation system as companies. Credit unions would be taxed on all interest income received (from members or otherwise). Income distributed as dividends would not then be deductible to the credit union but would carry imputation credits offsetting, to the appropriate extent, the tax members would bear on those dividends.

That option was rejected for two reasons. First it has high compliance costs for relatively unsophisticated taxpayers. Secondly, a payment in the form of a dividend to members may be partly an equity return (and therefore properly treated under the imputation system) but is more substantially a return on a savings deposit. As such it is more properly treated as interest which should be deductible to the union and fully assessable in the hands of the recipient.

The third, and recommended option, is to treat returns to credit union members as interest deductible to the credit union and assessable to the member. That would seem to be best achieved by incorporating credit unions into the taxation regime applying generally to co-operatives under section 199 of the Income Tax Act. Broadly, under section 199, co-operatives derive two types of income: income derived from dealings with members, and other income. Distributions of the latter are taxed as normal dividends under the imputation regime. Distributions of income derived from dealings with members are, at the option of the co-operative, taxed as either normal dividends under the

imputation regime or as the equivalent of interest under a deduction system whereby dividends are deductible to the co-operative but fully assessable in the hands of members.

We propose that credit unions be given the option of applying the normal co-operative regime or of accounting for all distributions as being from income derived from dealings with members and thus able to use the deductible option. If the latter option were adopted, for that income year the union would be exempt from the requirement to keep an imputation account, although it could do so if it so wished. This would reduce compliance costs in apportioning income between the two categories and would recognise that to a large extent credit union dividends are in fact interest payments for funds lent rather than returns on equity.

#### 7.4.2 Deductible expenditure

The tax system for credit unions would otherwise apply normal tax rules. We do not support the submissions asking for deductions for reserve provisions or for imputed voluntary labour. There is no reason for credit unions to gain a deduction for reserves other than in the normal way as a bad debt write-off. A deduction for imputed voluntary labour is not provided for elsewhere in the Act. The offset is that such imputed income is not taxed as income of the provider of the labour.

#### 7.4.3 Capital gains

The Committee considers that credit unions should be treated the same as the banking industry, which is taxed on net realised capital gains in accordance with general law (rather than by a specific tax on capital gains).

#### 7.4.4 Low interest loans to members

As already noted, the suggestion that credit unions should be taxed on the extent to which they provide low interest loans to members was the most strongly resisted of all possible measures raised. We have therefore considered this issue carefully. We have concluded that, as a general rule, credit union members should be placed in a similar position to company shareholders receiving similar loans. The Government has proposed that a company providing such loans to shareholders should be subject to FBT on the extent to which the interest rate on loans to shareholders is less than the prescribed rate for FBT purposes. This recognises the fact that such loans are an alternative means of distributing corporate income to shareholders.

We can see no justification for a general exemption from this rule with respect to credit unions. However, strict application of this rule would create high compliance costs and probably make most credit unions non-viable. Accordingly, we propose that the smaller credit unions be exempt from the requirement to pay FBT on low interest loans to members. The Committee proposes that a

credit union be exempt from this requirement in each quarter where:

- the organisation existed and had assets under \$1m as at 1/4/89; and
- the organisation has assets under \$1m at all times during the quarter.

Our proposal would exempt the small credit unions presently in existence. In 1987/88, 30 credit unions had assets over \$1m and 210 had assets under \$1m. All new credit unions would have to pay FBT on interest discounts irrespective of the organisation's size. This recommendation parallels that made in Chapter 5 in respect of friendly societies.

We emphasise that this proposed exemption is based on the high compliance costs that credit unions would otherwise face rather than being a taxation concession specifically provided to credit unions.

#### 7.4.5 Tax rate

The Committee has proposed that credit unions be subject to the tax treatment applying to co-operatives with an option to account for all income as if it had been derived from dealings with members, thus avoiding the need for an imputation credit account. Consistent with this model, credit unions should be taxed at the company tax rate, presently 33%.

#### 7.4.6 Implementation date

Initially, it was proposed that the new taxation regime for credit unions come into place with effect from the income year commencing 1 April 1989. The Minister of Finance has subsequently announced a delay in implementation for at least a year. As the proposed taxation regime does not involve complex calculations and should fit within existing credit union systems, we were unconvinced that a longer transition period was needed or would be useful.

Nor do we agree with the argument that taxation changes should follow regulatory changes. Indeed, as made clear in the Consultative Document, the final form of the regulatory regime is dependent on the credit union taxation regime. Regulatory controls would be needed for taxation purposes to the extent that credit unions retained taxation concessions. Under our proposals the main distinguishing feature of the credit union tax regime would be the effective dividend deduction regime. The only control necessary for tax purposes would be that non-residents should not be allowed to be members.

The Committee proposes that tax come into effect from the income year commencing 1 April 1990.

## Recommendations

The Committee recommends that:

- a credit unions be subject to the tax treatment applying to co-operatives with an option to account for all income as if it had been derived from dealings with members, thus avoiding the need for an imputation credit account;
- b general tax law (rather than a specific tax) apply to realised capital gains;
- c any interest discount on loans to members, as measured by reference to the prescribed FBT interest rate, be subject to FBT, except where the credit union:
  - existed and had assets under \$1m as at 1/4/89; and
  - has assets under \$1m at all times during the quarter;
- d the tax rate applying to the income of credit unions should be the company tax rate, presently 33%; and
- e taxation of the income of all credit unions apply from the income year commencing 1 April 1990.











